Platinum Asia Investments Limited

Quarterly Investment Manager's Report

31 March 2018

Platinum®
ASIA INVESTMENTS LIMITED

ABN 13 606 647 358

Portfolio Update

by Joseph Lai, Portfolio Manager

Performance

(compound pa to 31 March 2018)

	QUARTER	1 YEAR	2 YRS	SINCE INCEPTION
Platinum Asia Investments Ltd	-0.5%	26.5%	21.9%	13.0%
MSCI AC Asia ex Japan Index	2.6%	25.1%	21.7%	15.0%

Net of accrued fees and costs. Portfolio inception date: 16 September 2015. Refer to note 1, back cover.
Source: Platinum Investment Management Limited, RIMES Technologies.
Historical performance is not a reliable indicator of future performance.

Net Tangible Assets

The following net tangible asset backing per share (NTA) figures of Platinum Asia Investments Limited (PAI) are, respectively, before and after provision for tax on both realised and unrealised income and gains. The January and February figures have been adjusted for the $0.04 fully-franked interim dividend declared on 27 February 2018 and paid on 19 March 2018.

	PRE-TAX NTA	POST-TAX NTA
31 December 2017	$1.2594	$1.2091
31 January 2018	$1.2779	$1.2069
28 February 2018	$1.2322	$1.1785
31 March 2018	$1.2077	$1.1655

Source: Platinum Investment Management Limited.

Top 10 Holdings

STOCK	COUNTRY	INDUSTRY	WEIGHT
Alibaba Group	China	IT	3.5%
Samsung Electronics	Korea	IT	3.1%
Axis Bank Ltd	India	Financials	3.1%
Ping An Insurance Group	China	Financials	3.1%
Kasikornbank PCL	Thailand	Financials	2.9%
China Overseas Land & Invt	China	Real Estate	2.8%
Yes Bank Ltd	India	Financials	2.5%
Tencent Holdings	China	IT	2.4%
China Oilfield Services	China	Energy	2.2%
Jiangsu Yanghe Brewery	China	Consumer Staples	2.1%

As at 31 March 2018. Refer to note 3, back cover.
Source: Platinum Investment Management Limited.

Markets across Asia were lacklustre over the quarter as a result of concerns over rising interest rates in the US, with the Philippines (-8%), India (-5%), Korea (-1%) and Hong Kong (-1%) all posting weak returns (in local currency terms). PAI's portfolio had a flat performance over the quarter and returned 26.5% over the last 12 months.

Among the stocks that fared well were companies that are strategically positioned to service the burgeoning Chinese middle class consumer, particularly the Chinese healthcare stocks (United Labs +28%, 3SBio 15%) and gas utilities (ENN Energy +26%). Mining group MMG rose +23%, encouraged by recovering copper prices.

Our Indian, Philippines and Korean holdings detracted from performance, including the Indian banks (Axis Bank -9% and Yes Bank -3%), Philippines developer Ayala Land (-8%) and Korean internet search portal Naver (-9%). Their weak performance this quarter has not changed our investment

Portfolio Disposition

REGION	31 MAR 2018	31 DEC 2017
China ^	45%	53%
Hong Kong	4%	3%
Taiwan	2%	2%
India	13%	11%
Korea	10%	12%
Thailand	5%	5%
Philippines	2%	3%
Singapore	1%	1%
Malaysia	<1%	<1%
Indonesia	<1%	1%
Vietnam	0%	1%
Cash	17%	8%
Shorts	-2%	0%

^ Inclusive of all China-based companies, both those listed on exchanges within China and those listed on exchanges outside of China.
Refer to note 2, back cover.
Source: Platinum Investment Management Limited.

For further details of PAI's invested positions, including country and industry breakdowns and currency exposure, updated monthly, please visit https://www.platinum.com.au/Investing-with-Us/Investment-Updates.

thesis for these companies, which we continue to regard as quality businesses in the region and which we expect will rebound when market volatility recedes.

Commentary

During the quarter, the issue of increasing trade confrontation between the United States and China came to the fore. These certainly aren't easy negotiations to have and there has been much tough rhetoric over tariffs from both sides. Nevertheless, a full-blown trade war is probably unlikely to eventuate, mainly because both parties recognise the negative impacts it would have on their respective economies, an outcome that neither wants. So far, the US has proposed tariffs on about US$50 billion worth of Chinese imports. The Chinese side reciprocated with proposals for an equivalent amount over US imports, plus some vague promises of further opening-up of its domestic markets to foreign competition. US$50 billion is no negligible amount, but put in context, it represents less than 3% of China's total annual exports. It is worth remembering that while the US still makes up a significant 19% of China's exports, **nearly half of China's total exports are going to other Asian trade partners!**

We are further comforted by the belief that the impact of the current trade friction on the medium- to long-term earnings power of our portfolio companies will be limited. Our key Chinese holdings are businesses that are strong beneficiaries of China's growing middle class, domestic consumption upgrades and ongoing urbanisation. The portfolio is positioned to benefit from the continuation of China's economic reform measures, such as those focused on reducing environmental pollution and providing more sustainable growth, improving the health of the banking system, and delivering better healthcare for the people. Indeed, the recent constitutional amendment to remove the presidential term limit may be a positive for China's economic development as it cements President Xi's position and allows him to pursue his reform agenda with greater certainty.

Worth highlighting are some of the interesting changes we see taking place on the ground in China, and how the reality may be different to the picture painted by Western media.

You may remember watching a *60 Minutes* report on China's "ghost cities" back in 2013 – empty apartments with no one living in them. That was not exactly fake news, but it is certainly old news. If one can picture nearly 20 million people, almost the population of Australia, moving from rural villages to the cities every year, one can appreciate the scale of this migration. Empty apartments, to the extent that they exist, get filled up pretty quickly.

The truth is that instead of empty streets we see traffic jams, instead of unsold apartments we see a severe shortage of supply – so much so that buyers are going into lottery draws to get theirs hands on them. To meet this demand, developers are buying land and starting construction again!

You may have also read about the glut in China's supply of steel, aluminium, cement and so on. But that, too, is yesterday's news as the government has closed down numerous loss-making or polluting plants and factories over the last few years. As supply shrank, commodity prices recovered. Australian coal and iron ore producers have reported how their profitability improved out of sight! The CEOs of the remaining Chinese companies in these industries are telling us the same thing. With improving profitability, not only are they now able to keep up with the interest payments on their debt, they are also paying down the debt. The positive repercussions on the banking system cannot be under-estimated.

Moving onto the environment – China is more focused than ever on this issue. The drive comes from both the people and the top. "To bring back the blue sky!" hasn't been an empty political slogan; there has been real government action in enforcing the environment standards and regulations. Academic studies done by groups outside of China are reporting improvements in air quality in some Chinese cities by as much as 40% between 2013 to 2017.

We are living in exciting times in which the world is generating remarkable businesses through technological change. This is especially so in China because it is pursuing new technologies at a scale and pace that is unrivalled by most other countries. China has put in place first-class infrastructure and invested heavily in education (this includes both government funding and private spending), producing four million STEM (science, technology, engineer and maths) graduates a year. If you are an entrepreneur wanting to open a smartphone or electric vehicle factory, China is unique in its offering of an abundance of cheap and experienced engineers, an unparalleled supply chain and a huge domestic market to sell into. This is exactly what the assembler of the iPhone (Hon Hai Precision Industry) has managed to do, adding a hundred thousand people to its smartphone factory within a year.

Since China is brimming with entrepreneurs, competition is intense. But competition forces innovation and accelerates the iteration of products. Alibaba and Tencent have been locked in a race to win market share in mobile payments, each offering low fees and continuously improving their services. The result of this race is the growing number of Chinese cities that are fast becoming cashless. Mobile payment volume in China grew from zero to US$9 trillion in just three years – 10 times the volume in the US!

Building on its popular digital payment app Alipay, Alibaba now offers the largest cash management product in the world, with more than US$300 billion under management. PAI has owned Tencent and Alibaba for some time and they have generated good returns for the portfolio. The point is that China's vibrant private sector is capable of creating vast new businesses and tremendous value.

The growing power of the Chinese consumer is a well-told investment story. What may be less obvious is that while more and more Chinese are car owners and almost every adult has a smartphone, they are yet to take up the more intangible products that will improve the quality of life. Healthcare and insurance are prime examples.

The Chinese healthcare market is a quarter of the size of the US or European market by value, while its population is four times bigger. One of the portfolio's holdings, 3SBio, makes a drug called Enbrel, which is a biologic drug for the treatment of rheumatoid arthritis. Enbrel is the seventh top selling drug in Australia and a top 10 drug in most developed countries. But Enbrel doesn't even rank in the top 100 in China, because domestically 3SBio only has 30,000 patients at present. Among a population of 1.3 billion people, many sufferers of rheumatoid arthritis are not diagnosed and treated. But this is now changing as healthcare coverage expands.

Insurance has been another area of interest for us. We own Ping An Insurance, an industry leader in China. Ping An has a superb sales force and has invested billions of dollars in technology with great foresight. Its system allows auto insurance customers to lodge claims on their smartphones by simply submitting a photo of the accident, and Ping An's artificial intelligence algorithms will assess the damage and provide an estimate of the cost of repair in a matter of minutes.

The companies mentioned above are industry leaders with strong earnings power. Yet, we were able to purchase their shares at very attractive valuations. We are optimistic about their growth potential as China's consumers upgrade their spending.

Changes to the Portfolio

Given the enthusiasm of the market at the beginning of the year, we have taken the opportunity to book profits in the stocks that have reached our estimate of fair value. The portfolio's net invested position has been reduced to around 81%.

With a focus on industries and companies that are well positioned to benefit from the economic reforms taking place in China and India, as well as the cyclical recovery across the Asian region, we are deploying cash to buy companies that have strong long-term fundamentals but whose valuation is depressed amidst short-term market volatility.

Outlook

With the recent correction in the markets, the outlook may in fact be looking more sanguine. Notwithstanding the present concerns with rising interest rates in the US and deteriorating US-China trade relations, the Asian region continues to provide a fertile ground for interesting ideas.

Macro Overview

by Andrew Clifford, CIO, Platinum Asset Management

Over the course of the first quarter of 2018, a number of issues have arisen that gave investors reason to return to a more cautious stance despite the global economy continuing to grow robustly. Among these concerns are:

- rising interest rates in the US,
- the impact of China's financial system reform on that country's economy and on asset markets both inside and outside of China, and
- the potential for a trade war between the US and China.

Over the last year, we have highlighted that rising US interest rates are the most likely source of a setback for the economic outlook and for markets. In developed economies, historically the pattern has been that initial increases in rates have little impact on growth, but as rates continue to rise, they will eventually act as a handbrake on the economy. As for whether the next rate hike will be the straw that breaks the camel's back, it is difficult to foretell even at the best of times. After a period of quantitative easing and near zero interest rates, the task is perhaps even more challenging. That debt levels remain elevated across most of the major economies adds further complexity to the problem!

For the moment though, it is clear that the US economy continues to travel well. Employment is strong, with initial unemployment claims (an indicator of new job losses) at the lowest level in 45 years. Wage growth remains healthy (average hourly earnings growing at 2.5% annually), and workers continue to be attracted back into the workforce with the participation rate[1] gradually rising. While the concern is that higher wages will ultimately be passed along through higher prices, for now, inflation in the US remains subdued at 1.9%.[2] The current scenario of steady gains in employment with wages rising and little evidence of inflationary pressures to date appears to be a very positive one.

We would think investors faced with this scenario would remain relatively optimistic about their prospects, and through January they appeared to be so. Of course, the environment can change quickly, and the big change was President Trump's tax cuts which were passed by Congress in December. The stock market's first reaction was clearly welcoming of the change as US companies would see a significant lift in their after tax profits. However, there are other impacts to be considered. Firstly, as tax cuts flow through to US corporates and households in the months ahead, one would expect them to boost the economy to some degree as a result of either increased consumption or more investment. The risk is that these cuts will add fuel to an economy that is already growing strongly, thus causing greater inflationary pressure and possibly an acceleration of interest rate hikes.

The secondary issue is that the consequential increase in the country's fiscal deficit – which is expected to rise from 3.7% of GDP currently to around 6% of GDP in 2020 as a result of the tax cuts – will see a significant increase in the amount of government bonds that need to be issued, with the potential to move long-term interest rates higher. In some respects, this increase in the supply of government bonds looks even more dramatic when one considers that there was a *net negative supply* not very long ago – the bond purchases made by the Federal Reserve in 2012-13 under their quantitative easing policy were greater than the new bonds issued. Viewed in this light, the net supply of new bonds will effectively have moved from less than zero to over 6% of GDP in the space of six years. And all this is without taking into account how President Trump's other policy initiatives (such as infrastructure spending) might further stretch the deficit and add to the bond-issuing task!

It is easy to start envisaging both long- and short-term interest rates moving much higher than previously expected, in the process upsetting economic growth prospects and indeed equity and debt markets. We will address the issues for markets later in this report, but first it is worth noting that in the period prior to the tax cuts being passed, the 10 Year US Treasury Note was trading at a yield of around 2.35%, and subsequently ran up through the first months of the year to just below 3%, before settling back at 2.8%. It is easy to see why some commentators are excited about bond yields going much higher even though the US government's bond-issuing task hasn't even started.

The problem with this analysis is that while we have an approximate idea of the future government deficit, there are many variables that no one can fully predict. As an example, to what extent will consumers spend their tax cut or save it,

1 Of 25 – 54 year olds.

2 CPI ex Food and Energy.

and will companies invest more or simply pass it through to shareholders in the form of dividends and buybacks? The degree to which this happens will not only have an impact on the strength of the economy and on inflation, but also on the amount of savings in the economy available to purchase the bonds. In addition, the move in the US 10 Year Treasury yield to 2.8% may already be sufficiently attractive for investors to fund the deficit, especially for the European and the Japanese whose equivalent rates in their home markets vary between zero and around 1.5%. Ultimately, the economic and financial systems we are dealing with are dynamic and the simplistic predictions are often wrong.

The other important development is the ongoing reform of the Chinese financial system, a topic that has received relatively little coverage in the Western media. The key change that has been causing concern is a directive that requires the assets and liabilities of the shadow banking system be brought back onto the balance sheet of the sponsoring financial entity. The issue is that banks and other financial institutions are required to have a minimum level of shareholders' funds (or equity capital) for a given level of lending, and bringing these shadow banking assets back onto the balance sheet will lead to many banks breaching these capital adequacy requirements. The solution is relatively straightforward: limit new lending and seek repayments of loans where possible.

There is, however, the additional complication that the loans funnelled to the shadow banking system and kept off balance sheet were loans that the banks would have otherwise been restricted from making. Also, the regulator has tightened up on the use of Chinese banks' balance sheets to fund the purchase of offshore assets. The result is a forced deleveraging by companies, particularly those that have taken on significant debt to acquire assets both at home and overseas. An example well publicised here in Australia is the divestment by Wanda, a Chinese shopping mall developer, of a major residential project at Sydney's iconic Circular Quay. Other names impacted include HNA Group (airline operator turned real estate and hospitality conglomerate) which now has a stake in Virgin Australia, and Anbang Insurance, whose vast portfolio of assets includes the Waldorf Astoria in New York.

In conjunction with these changes, China is looking to further develop its domestic bond market in order that companies and local governments can borrow money in a more transparent fashion. The issue is that this mechanism will take time to replace the shadow banking system as it is today, and as a result the availability of loans will be much reduced. Indeed if we look at the broadest measure of credit growth in China, it has now slowed to 12.9% year-on-year, a relatively subdued level by Chinese standards. The question then is what impact this tightness in credit availability will have on the Chinese economy and asset prices both inside and outside of China.

On the economic front, our expectation is that there will be relatively little impact. The dynamic, growing part of China's economy is predominantly the private sector which has traditionally had relatively poor access to credit. Another area of growth has been government sponsored infrastructure spending, an area to which we expect credit will remain readily available. While we may well see ongoing forced divestitures of assets by some groups, they remain as much an opportunity for those that are in a position to buy as they are a problem for the sellers. Simply, we don't see this as a problem for the economy, and as investors, you want to be an owner of the companies buying, not those selling. Finally, we would note that as a result of these concerns the Shanghai A-share market has retreated over 10% from recent highs and remains at levels reached in late 2016 when the economy was still in relatively early stages of recovery.

President Trump's decision to apply tariffs on US$50 billion of Chinese imports and China's response to do likewise for a comparable amount of US imports have sparked concerns of trade wars and potentially a broader decline in free trade. It should be noted that these announcements are of *intentions*, and there will be months of deliberation domestically in the US and opportunities for negotiation between the two countries. Most commentators assume that negotiations will yield some compromise on starting positions as well as some concessions granted by China to US demands for removing existing trade and investment barriers. We consider such a compromise the most likely outcome. But even if these tariffs end up coming into force, their broad economic impact on both sides will probably not be particularly significant.

The greater risk here is the political environment, present in much of the Western world, which makes the idea of such policies politically appealing. At the core of the issue, we believe, is that low income households have shared relatively little of the prosperity of the last 30 years and, as such, see no great downside from the end of ideals such as free trade. As governments continue to fail to address the issue of income disparities, it is likely that populist policies will remain part of the landscape across the developed world. The other issue that is unlikely to fade away is the instability of the Trump administration. A particularly concerning move by President Trump was to allow reciprocal visits between senior US and Taiwanese officials. While China's initial response to the announcement of import tariffs was measured and constructive, the response from President Xi on the Taiwan announcement was much stronger.

Market Outlook

While interest rates rarely make for a particularly enthralling discussion, at times they are critical for outcomes in markets. The reason is that the rate of return from owning cash or government bonds is the anchor off which all other assets are priced. The higher the yield on a government bond, the greater the return investors will demand from any given stock (all else being equal[3]), which in turn means a lower share price. A significant increase in interest rates therefore can be a catalyst for equity markets to move lower.

We think this is particularly true today, as many of the popular or fashionable investments of the moment will likely be very sensitive to interest rate moves. As we have stated over the last year, if there is an accident in financial markets waiting to happen, we suspect it is most likely to happen in the debt markets. Many investors in an attempt to avoid risk in recent years have crowded into bond funds, and the room for disappointment there is significant.[4] Other popular investment strategies such as risk parity funds,[5] we suspect, will also be susceptible to higher interest rates. Some observers attributed the initial sell-off in February to activity by risk parity funds.

Undoubtedly, low interest rates have played a significant role in bringing about the very high valuations currently attributed to fast growing companies. While the share prices of Facebook, Amazon, Netflix and Google (now Alphabet) – the so called 'FANG' stocks – are mentioned in almost every financial news report, the reality is that these companies represent just one part of the extreme market valuations reached in recent months.[6] We have seen similarly high valuations across a range of companies in biotech, medical devices, artificial intelligence, autonomous vehicles, and even some in the consumer sector. Companies on such inflated valuations are very susceptible to a setback, should rates move higher.

Our problem, as stated earlier, is that the art of predicting where interest rates will go and when the moves will happen is a highly imprecise one. The broad statement we can make is that we are in an environment where interest rates are rising and that this will act as a dampener on markets. Ultimately our outlook for the next three to five years is guided by the returns implied in the valuations of the stocks we hold in our portfolios and the ease with which we find new ideas to buy. On this front, we are optimistic on future investment returns over the medium-term.

In the next 12 months or so, besides the question of interest rates, the trade policies of President Trump are likely to be a major focus for markets. We think trying to predict outcomes on this front is even more problematic than forecasting interest rates. Our approach to managing the associated risk is to simply ensure that we have cash reserves in our portfolios to take advantage of any trade war-inspired sell-off.

3 Which, of course, it never is! On a day to day basis, higher bond yields might mean better economic growth and thus better profits for a company.

4 As bond yields rise, the prices of bonds fall. So the investor expecting bonds to be a safe haven may be disappointed.

5 A risk parity strategy is one that is focused on the allocation of risk (usually defined as volatility) across different asset classes, rather than allocation of capital.

6 We would argue that Google and Facebook have been quite reasonably valued.

A Consistent Approach for Investing in an Ever Changing World

by Andrew Clifford, CIO, Platinum Asset Management

This is an edited rendition of Andrew Clifford's presentation at the 2018 Platinum Investor Roadshow in Sydney. To view a video of this and other presentations from the Roadshow, please visit www.platinum.com.au/Insights-Tools/The-Journal/2018-Roadshow-Presentation.

How the world has changed since 30 years ago

Back in October 1987, a little over 30 years ago, I was sitting at home, working on my final assignment for university. It was a thesis on the pricing of currency options. As I typed away at my PC while listening to the radio, on came the news of some extraordinary events starting to take place in the stock market. I switched from Triple M to the ABC and spent the next few days glued to the radio as the historic '87 market crash unfolded.

At this stage, Kerr had already offered me a job at Bankers Trust in a team of four that managed the equity funds. But there were some interesting things as I reflect back on this time. In the weeks following the crash, I started receiving letters from the other financial institutions that I had been interviewing at, informing me that there was no need to come in for further interviews. It wasn't that they didn't want me, the letters explained, it was just that they were cancelling their graduate intake for 1988.

It's extraordinary how short-termed people's mindsets are in business, particularly in finance.

I did eventually stop to wonder whether I still had a job at Bankers Trust. Fortunately, I did. When I arrived there in January 1988, I was immediately struck by something very different about this place. October '87 was not seen as a threat, or as a crisis. It was seen as an opportunity.

30 years ago doesn't feel like it's been a very long time for me. But it's worth reflecting on how much has changed over this period. I was listening to an FM music station. It was the disruptive technology of the '80s. Commercial FM had been around for seven years and had wiped out the AM stations that hadn't made the move. The radio, the TV and the newspapers – they were where we got our news from. Nowhere else.

I was unusual among university students in those days to have a personal computer at home. I borrowed $4,000 from my grandmother to buy it and a printer. It was an IBM XT clone – a copycat of the real thing. If you had bought the actual IBM XT back then, it would have set you back $20,000 – about $40,000 in today's terms – and all it could do for you was some word processing, some spreadsheets and a little bit of primitive coding.

And that thesis that I was working on – currency option pricing – it was the leading edge financial engineering of the day, though pretty tame compared to the weird and wonderful things that the derivatives desks come up with today.

Besides these obvious changes in technology – the Internet, e-commerce, mobile phones, the revolution in healthcare and biotech – over those 30 years we have seen the rise of China and India. It has been an extraordinary 30 years, and this period of incredible change is important to the way we see opportunities (I will return to this later).

How our investment approach has stayed the same

The other thing that struck me about Kerr's team at Bankers Trust back then was that there was a very clear view about how we needed to invest to achieve good outcomes – to find undervalued companies. Furthermore, there was also a clear view about where such undervalued companies were to be found. First, we looked in those parts of the market that were out of favour, that no one else was interested in, the unloved companies, industries and countries. Second, we looked in areas where there was a great deal of change going on. The other side of the coin of the search for undervalued companies was the avoidance of the fashionable or popular investment ideas of the day.

In 1989 I took on the management of the BT Select Markets Pacific Basin Fund. In 1989, the Indonesian stock market had just opened up to foreign investors, and there were a total of eight stocks that we could invest in. My first visit to China was in 1990. There was no stock market in China in 1990. The first stock listing in China did not happen until 1992. Where was the fashionable place to be in 1989? Where did one have to be invested in? It was Japan, which was 40% of the world market back then. And what did we at Bankers Trust do with Japan in 1989? Absolutely nothing. We did not spend a single minute on a Japanese company or on that country for at least another three years, by which point the Japanese market had fallen 60%. This was an approach that was rewarded with very good investment outcomes back then.

In early 1994, Kerr left Bankers Trust. He invited myself, Liz Norman, Jim Simpson, Toby Harrop, Malcolm Halstead and Michele Martinez to help start up the business of Platinum. The premise of starting this business was simple. We had an investment approach that we knew would generate good returns for our clients. This was what we would do. We would not be all things to all people. We would simply deliver good investment outcomes using an approach that we understood.

This investment approach – the idea of avoiding the crowd, looking for what's out of favour, and focusing on what's changing – is easily enough said. But at the core of this approach are the cognitive biases that each and every one of us has. They are a fundamental part of human behaviour. We've had in print for over 15 years this little book, *Curious Investor Behaviour*, which outlines some of these behavioural challenges that we all face as investors.[1]

We can talk about these cognitive biases one by one – attribution bias, confirmation bias, loss aversion, and so on. There are many of them, but the lesson is the same. Our intuitive response to many questions – particularly investment questions – will often lead us to making the wrong choices. If I put to you any kind of investment idea, you would have an immediate intuitive response – it's a good idea, or it's a terrible idea. If I asked "is it a good idea to invest in Sydney residential property", many of you would say yes while others would say no and many would find themselves somewhere in between.

The question we should be asking is "what's the underlying evidence", or "how do the facts stack up with our feelings". The key to remember is that ***great opportunities occur when our conviction is low but the evidence – the facts – is strong***.

With this in mind, I'd like to now return to the two opportunities presented earlier tonight by Dr Joe Lai and Clay Smolinski: China and electric vehicles.

China – an extreme case of the "out-of-favour"

China hasn't just been a deeply out-of-favour market in recent years. It has been seen as a major risk to the global economy as well as to global markets. China is the world's second largest economy. But in terms of physical output, be it cars, mobile phones or commodities, in many respects it is the world's largest economy. The problem with China which we all know too well is that the country was experiencing excessive growth in the use of debt, it had a massive oversupply in a range of industries, and property speculation was wild… All of this led to fears that there would be a massive blow-out in bad debts for the banking system and a possible financial crisis. You could not have been reading the financial papers in the last three years (at least until last October) and not be hit on the front page at least once a week by an article by some expert explaining why China was an accident waiting to happen, why it was a disaster in the making.

What was your intuitive response – after being hit with that narrative of impending doom day after day, week after week – to the idea of investing in China? For most of us, the intuitive response would have been – and was – one of extreme caution. And that was exactly how we felt as well.

But the one thing that we have learned from experience and practice is to look for that type of intuitive response, to recognise it for what it is and, instead of going with it, to examine the underlying evidence.

So what was the underlying evidence in China? Indeed, there was a massive problem with the rapid expansion of debt, over-capacity and a looming bad debt crisis. There was no doubt that these problems were all real. But by mid-2014 the Shanghai stock market had experienced one of the worst bear markets of all time. So at least we knew that the Chinese had worked it out as well, that it was no mystery.

If you kept watching in 2015, you would have noticed that the government was starting to spend money on infrastructure. Just as governments around the world do – when their economy is slowing, they spend money. The Chinese economy was responding to the infrastructure spending which became part of the now well-known One Belt One Road program.

If you kept watching in 2016, you would have observed the supply-side reforms that the government brought in to close down the uneconomic and polluting capacities in steel and coal industries. Continued into 2017 and with a particular environmental focus, the capacity closures and other reform measures saw profitability improve across a whole range of industries: steel, coal, chemicals, cement, glass, fertilisers… As profitability improved, so did the enterprises' ability to pay back their debts.

Coal companies were telling us in late 2016 that some 40% of the industry's debt was non-performing at the start of the year, but by the middle of the year that number was negligible. The non-performing debt issue was already on the mend. Should this have been difficult for any of us to see? As Australians, it was in fact hard to miss. The coal price was up

1 You can order a free copy of *Curious Investor Behaviour* and read our other publications on the topic of behavioural finance at www.platinum.com.au/Insights-Tools/Investment-Fundamentals/Curious-Investor-Behaviour. For more in-depth studies on cognitive biases, you may consider reading *Thinking Fast and Slow* by Daniel Kahneman who, together with Amos Tversky, pioneered the field of behavioural economics.

150% in 2016. The iron ore price doubled. There was very clear evidence that change was afoot.

What came next was a very significant recovery in China's residential property market. Then, since last year, that very scary-sounding "shadow banking system" which China had become well-known for (we have one, too, here and in the US – it's called securitisation) has been the subject of very significant reform and regulation.

Much has been changing. But the most important thing to observe about China over this period is that there was a thriving private sector which, outside of the property industry, had little reliance on credit.

All of these facts were evidence that there were many good reasons to be positive about China. Yes, non-performing loans could be an issue, the shadow banking system needed reform, and capital flight needed to be reined in… But these problems did not support wholesale negativity about the country.

Why is this important? Firstly, the disconnect between investors' feelings about China and the underlying facts provided us with great opportunities to buy Chinese companies at extraordinarily low valuations. Secondly, the changes taking place in China also had significant impacts on companies outside of the country. As mentioned above, coal and iron ore were the most obvious examples for Australia, but there were many more such themes across the world. More importantly, even if you didn't want to invest in China, keeping your eyes on the evidence would have made it clear that, while the debt problem posed risks to the rest of the Chinese economy and to markets, those risks were not nearly as great as many commentators made them out to be.

Since the end of 2017 investors have been more relaxed about China. It's not clear to us why that is the case. But what we do know is that investors are still a long way from embracing China for the opportunity that it is today, and we think there is much more money to be made there.

Electric vehicles – the challenge of imagining change

Electric vehicles are another interesting illustration of our investment approach. It is very different to the China story.

Like the looming downfall of China, the imminent rise of electric vehicles is a story which you will find in the papers nearly every week. What's different is that there is in fact a great deal of evidence in favour of the developments that one often hears. We all know about Tesla. It has been a great investment for those who bought it at the right time. We also know from the Australian market that the price of lithium (a key component in batteries) has risen significantly and many local investors have made good money from some of the locally-listed lithium producers. But elsewhere – BMW, Daimler, Nickel, Copper, Cobalt – these businesses are not attracting much interest from investors.

As an aside, think back to 10 years ago, when Amazon and e-commerce were already a well-established phenomenon and the iPhone was already in its second year and many of us already had a smartphone. The damage e-commerce was going to cause to traditional retailers should already have been clear to everyone then. Of course, it is easy to say with the benefit of hindsight. But how many of us invested in Amazon or other e-commerce companies a decade ago, or at least got rid of those brick-and-mortar retailers from our portfolios? It was obvious. But how many of us saw it coming? We didn't do it particularly well, and well done to those who did, but most of us didn't. And why didn't we? Because, with our cognitive biases constantly coming into play, it is just so hard to imagine a world that is so different. And it is also incredibly hard to think in timeframes of 10 years or more.

So that is where we are at with electric vehicles. If I told you that in 10 years' time every new vehicle you buy will either be an EV or a hybrid EV of some form, would you believe me? How readily would you accept this estimation? Probably not with ease.

But here's the evidence. In two of the world's largest auto markets – China and Europe – regulations are going to drive EV adoption. Global automakers are investing – or have invested – billions of dollars in EV research and development. All of them are bringing electric and hybrid models onto the market over the next two to three years. Take BMW as an example. The company has already launched its 3 Series and 5 Series in some markets around the world in plug-in hybrid versions. In many of those countries the plug-in hybrids cost the same as the diesel engine version of the same model, and many consumers have swiftly made the switch. By last December, some 30% of the 3 Series sold in the UK were plug-in hybrids.

And then there is the significant activity by the battery makers and the auto companies who are literally running around the world desperately trying to secure supplies of Cobalt and Nickel in order to ensure that they have enough raw materials for their batteries and cars.

The China story is one where the intuitive response was one of exaggerated fear and concern. With electric vehicles, the opportunity comes from the under-estimation of the scale and the pace of change. It's just hard to envision a world that's going to be so different in a decade's time. But again, the evidence is what we need to focus on.

This is what we do at Platinum

So, this is what we do. We look for those areas that others aren't interested in or even fear. We look for areas where there is a great deal of change going on. We do our homework to examine the evidence and this is where we spend most of our time. We need to understand the outlook for the companies we are considering buying, to have an idea of their earnings potential over the next five years and beyond. This then allows us to assess whether their share prices are cheap or expensive in terms of the future returns they imply for the owner of those shares. We do this for a large universe of companies around the world, and we build up our portfolios company by company.

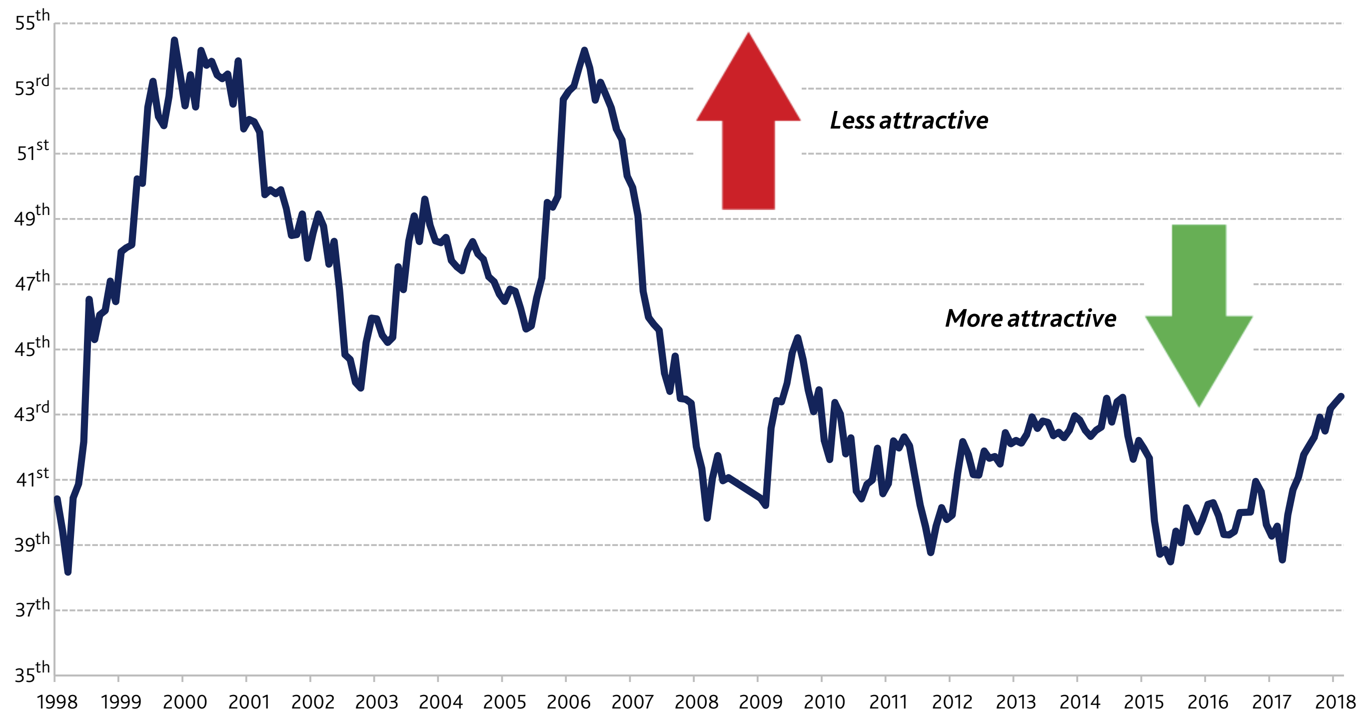
At times we can be very confident about the result we expect to achieve, simply because of those implied future returns. The following chart illustrates one of the ways in which we assess the attractiveness of our portfolios using a combination of four factors. The first is the valuation of the companies in the portfolio. The second is the profitability of the companies, followed by growth and the level of debt that these companies have. To us, this composite "quant score" is an indicator of the future potential of the portfolio. Back in 2016,[2] this chart showed that the portfolio of the Platinum International Fund (PIF) was as prospective – that is, it implied as good a return going forward – as we had seen at any time in PIF's history. We stressed this a number of times in our quarterly reports throughout 2016. Indeed, since then returns have been very good.

Of course, returns will vary from year to year. At times markets can be slow to recognise the underlying potential of the companies we own, as they have been with China in recent times. But we do expect that, by adhering to our approach, we will produce good investment outcomes for our clients over the coming years, just as we have done over the last 24 years.

2 The 31 March 2016 quarterly report (https://www.platinum.com.au/PlatinumSite/media/Default/ptqtr_0316.pdf) for the Platinum International Fund included the same chart (up to 31 March 2016), though with the four components displayed separately, as well as detailed explanation of what these metrics represented.

Platinum International Fund – Portfolio Quantitative Score (as at 28 February 2018)
Composite measure of value, leverage, growth and profitability

Percentile (relative to global opportunity set)



Source: Bloomberg; Factset; company reports; Platinum.

Platinum®
ASIA INVESTMENTS LIMITED

Level 8, 7 Macquarie Place
Sydney NSW 2000

GPO Box 2724
Sydney NSW 2001

Telephone
1300 726 700 or +61 2 9255 7500
0800 700 726 (New Zealand only)

Facsimile
+61 2 9254 5555

Email
invest@platinum.com.au

Website
www.platinumasia.com.au

Notes

Unless otherwise specified, all references to "Platinum" in this report are references to Platinum Investment Management Limited (ABN 25 063 565 006 AFSL 221935). "PAI" refers to Platinum Asia Investments Limited (ABN 13 606 647 358) (ASX code: PAI).

1. The investment returns are calculated using PAI's pre-tax net tangible asset (NTA) backing per share (as released to the ASX) and represent the combined income and capital returns of PAI's investments over the specified period. Returns are net of accrued fees and costs, and assume the reinvestment of dividends. Note that performance is not calculated based on PAI's share price.

   The investment returns shown are historical and no warranty can be given for future performance. Historical performance is not a reliable indicator of future performance. Due to the volatility in PAI's underlying assets and other risk factors associated with investing, investment returns can be negative, particularly in the short-term.

   PAI's returns have been provided by Platinum. The MSCI All Country Asia ex-Japan Net Index (A$) returns have been sourced from RIMES Technologies. Index returns are in Australian dollars and assume the reinvestment of dividends from constituent companies, but do not reflect fees and expenses. For the purpose of calculating the "since inception" returns of the MSCI index, PAI's portfolio inception date is used.

   Platinum does not invest by reference to the weightings of any index or benchmark, and index returns are provided as a reference only. PAI's underlying assets are chosen through Platinum's bottom-up investment process and, as a result, PAI's holdings may vary considerably to the make-up of the index.
2. The geographic disposition of assets (i.e. the positions listed other than "cash" and "shorts") represent PAI's exposure to physical holdings and long derivatives (of stocks and indices) as a percentage of PAI's net asset value.
3. The table shows PAI's top 10 long stock positions (through physical holdings and long derivatives) as a percentage of PAI's net asset value.

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