Platinum® ASSET MANAGEMENT

# Platinum Global Fund®

ARSN 600 630 537

## Quarterly Investment Manager's Report

31 December 2014

# Platinum Global Fund

**Kerr Neilson** Portfolio Manager

## Performance

**(to 31 December 2014)**

| | QUARTER | SINCE INCEPTION (8 SEP 2014) |
|---|---|---|
| Platinum Global Fund | 8% | 9% |
| MSCI AC* World Net Index | 7% | 11% |

* Morgan Stanley Capital International All Country

Source: Platinum and MSCI. Refer to Note 1.

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

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

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

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

The Fund achieved +7.8% for the quarter and +8.8% since its inception on 8 September 2014, compared to +7.4% and +10.7% respectively for the Index.

**Currency**

The US dollar has remained our principal currency position at 72% (which includes 5% in the Hong Kong dollar).

We hold little Japanese yen and Australian dollar and are partially hedged out of the Euro, the Chinese renminbi and the Korean won.

### MSCI World Index Regional Performance (AUD)

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

Source: MSCI

### MSCI World Index Sector Performance (AUD)

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

Source: MSCI

## Changes to the Portfolio

The Portfolio has continued to build on its invested position since inception in September 2014.

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

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

### Geographical Disposition of Fund Assets

| REGION | DEC 2014 | SEP 2014 |
|---|---|---|
| Asia | 35% | 16% |
| Europe | 26% | 15% |
| North America | 23% | 19% |
| Japan | 9% | 15% |
| Russia | 1% | 0% |
| Australia | 0% | 2% |
| Cash | 6% | 33% |

Source: Platinum. Refer to Note 2.

## Commentary

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

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

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

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

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

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

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

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

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

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

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

## Outlook

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

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

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Platinum® GLOBAL FUND

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1. The investment returns are calculated using the Fund's unit price and represent the combined income and capital return for the specific period. They are net of fees and costs (excluding the buy-sell spread and any investment performance fee payable), are pre-tax, and assume the reinvestment of distributions. The investment returns shown are historical and no warranty can be given for future performance. You should be aware that historical performance is not a reliable indicator of future performance. Due to the volatility of underlying assets of the Fund and other risk factors associated with investing, investment returns can be negative (particularly in the short-term).

2. Invested position represents the exposure of physical holdings and long stock derivatives.

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