Platinum ASSET MANAGEMENT

# Platinum Global Fund®

# Quarterly Investment Manager's Report

30 June 2017

Platinum GLOBAL FUND

ARSN 600 630 537

# Platinum Global Fund

Kerr Neilson
Portfolio Manager

## Performance

**(compound pa, to 30 June 2017)**

| | QUARTER | 1 YEAR | 2 YRS | SINCE INCEPTION |
|---|---|---|---|---|
| Platinum Global Fund | 6.2% | 22.2% | 6.0% | 11.3% |
| MSCI AC* World Net Index | 3.7% | 15.3% | 7.0% | 12.3% |

Source: Platinum Investment Management Limited, RIMES Technologies.
Refer to note 1, back cover.
Historical performance is not a reliable indicator of future performance.
* Morgan Stanley Capital International All Country

The core themes that were established during the first quarter persisted through the second, namely, the notion of improved and widespread growth in economic activity across the world with accompanying improved sentiment and a willingness to take more perceived risk by raising exposure to Emerging Markets. The departure from the view of the first quarter was **a surprisingly weak US dollar**, which reflects the difficulties that the Trump Administration is having in the legislative process and investors' perceptions about relative growth rates. This showed in the **recovery in the Euro** which was accompanied by a notable increase in European bond yields. Clearly, the election of Emmanuel Macron as the new President of France and the improving political climate for Angela Merkel in Germany have also played a part as has the whispering around changing monetary policy by the European Central Bank. The prospect of a tighter working relationship between Germany and France, together with the economic reform promised by the new President, led to strong investment flows into European equities. The poor showing of Theresa May in the British general election may

### MSCI Regional Index Performance to 30.6.2017 (AUD)

| REGION | QUARTER | 1 YEAR |
|---|---|---|
| **Developed Markets** | **3%** | **15%** |
| **Emerging Markets** | **6%** | **20%** |
| **United States** | **2%** | **14%** |
| **Europe** | **7%** | **17%** |
| Germany | 6% | 25% |
| France | 9% | 24% |
| United Kingdom | 4% | 10% |
| **Japan** | **5%** | **16%** |
| **Asia ex Japan** | **8%** | **23%** |
| China | 10% | 28% |
| Hong Kong | 7% | 20% |
| India | 2% | 14% |
| Korea | 10% | 31% |
| Australia | -2% | 15% |

Source: RIMES Technologies.

### MSCI All Country World Sector Index Performance to 30.6.2017 (AUD)

| SECTOR | QUARTER | 1 YEAR |
|---|---|---|
| Information Technology | 6% | 32% |
| Health Care | 6% | 6% |
| Industrials | 5% | 19% |
| Financials | 4% | 30% |
| Consumer Discretionary | 3% | 17% |
| Consumer Staples | 3% | 1% |
| Utilities | 3% | 0% |
| Materials | 2% | 21% |
| Telecommunication Services | -1% | -5% |
| Energy | -5% | -3% |

Source: RIMES Technologies.

promote a less bellicose initiation of the Brexit negotiations than previously intimated, though it seems probable that the process will be to the detriment of confidence in the UK economy which is running an abnormally low savings rate.

Having initially been concerned about the **new measures to tighten lending in China**, investors came around to the view that this was a positive development, particularly as it was evidenced in practice by the closure of redundant capacity in industries like cement and steel. The remaining operations have subsequently seen significant improvements to their profits, much to the delight of their creditors and the Chinese banking system in general!

**India continues to grow strongly** at over 6% p.a. despite credit growth being at the lowest since the country's 1947 independence – about 4.5% p.a. (This is noteworthy for those who believe credit growth is a precondition for economic growth. It is not, but it does serve as a lubricant.) At last, GST is being implemented largely to the benefit of the states and carries a messy range of rates depending on the priority needs for particular goods and services. While improving the country's tax base is crucial, the reform of the insolvency law is quite as far-reaching. Under the Insolvency and Bankruptcy Code of 2016, a large portion of the state-owned banks' non-performing loans – estimated to constitute 10 to 15% of their 'assets' – will no longer be sheltered from recovery by archaic legal processes. The removal of this blockage will help the banks to clear the backlog of non-performing borrowers and the benefits will be felt in a more vibrant corporate bond market as larger firms seek alternative funding sources.

Overall, the Emerging Markets, in particular Asia, led again with a rise of close to 8% (in AUD terms), but the powerful fund flows into Europe ensured it wasn't too far behind, up 6.6% (in AUD). While the leading tech names sold off towards the quarter's end, they had a spectacular lift-off in late April, achieving the best returns in the MSCI sector indices for the quarter as a whole, along with healthcare. The laggard sectors include energy, telecoms and utilities. This suited our positioning greatly, with the Fund outperforming over the quarter and the last 12 months. The Fund achieved 6.2% for the quarter and 22.2% for the year, compared to 3.7% and 15.3% respectively for the Index.

Holdings that strongly influenced the Fund's performance over the quarter include tech holdings such as Tencent, Samsung Electronics and Alphabet (Google), luxury goods group Kering, Italian bank Intesa Sanpaolo, and Chinese insurer Ping An.

Detractors were again the energy stocks, such as TechnipFMC and Inpex.

## Currency

The surprise to us has been the recovery of the Australian dollar. Having been long the AUD, we eliminated most of our position, figuring that the US dollar would have responded more to the tightening (a narrower interest rate differential). We also sold down the Korean won into strength against the US dollar and added to the Yen and the Euro while removing the hedge on the Chinese yuan after it weakened. It wasn't our best quarter for reading currencies.

| CURRENCY | 30 JUN 2017 | 31 MAR 2017 |
|---|---|---|
| US dollar (USD) | 33% | 31% |
| Euro (EUR) | 16% | 12% |
| Hong Kong dollar (HKD) | 10% | 10% |
| Japanese yen (JPY) | 8% | 6% |
| Norwegian krone (NOK) | 7% | 7% |
| Korean won (KRW) | 6% | 8% |
| Indian rupee (INR) | 5% | 6% |
| Australian dollar (AUD) | 5% | 17% |
| British pound (GBP) | 3% | 3% |
| Chinese yuan offshore (CNH) | 0% | -7% |

Refer to note 4, back cover.
Source: Platinum Investment Management Limited.

## Changes to the Portfolio

It was a quarter characterised by opportunistic repositioning rather than adding many important new holdings. The strong run in tech stocks saw us trim positions in **Tencent**, **Samsung Electronics**, **Cisco** and **Ericsson**. We also reduced our exposure to European banks (**Lloyds**, **Intesa Sanpaolo** and **Mediobanca**) as they rose on improving prospects. The **gold ETF** and **Newcrest Mining** were removed. We haven't lost interest in this asset group, but for the moment are giving preference to producers of copper and nickel, like **Sumitomo Metal Mining** and **Norilsk**.

Additions were made to **Nielsen** after a period of share price weakness stemming from doubts around its video monitoring service and expenditure cuts by the consumer packaged goods companies. We also added **Alibaba**, because of its tightening grip on e-commerce and broader payment footprint in China. We bought more **Oracle** on the view that the market is about to treat them more seriously as a cloud provider. Its subsequent quarterly earnings call supported this view.

The significant new name in the portfolio is **Royal Dutch Shell**. Like others in the oil industry, the company has been shaken by self-inflicted problems that partly had their origins in booming oil prices which rose from the lows of below US$11 in 1999 to the highs of over US$120 per barrel in 2012. Following the fiasco of overstated reserves in 2004, Shell went through a rudderless period when it wasted huge amounts of capex in every direction. This changed abruptly in 2013 with the appointment of a new CEO and the company embarked on a complete re-appraisal of its future. There followed the opportunistic acquisition of BG in early 2016 which, together with earlier exploration outlays, secures the company's reserves for over 25 years. The resolution of issues around efficiency, costs and capital spending is well underway. This involves a wholesale change in management, greater centralisation, and the establishment of 150 discrete profit centres with very explicit performance targets. Possibly the most important change is the grafting of top BG personnel into key positions and other heads being appointed from the less profligate downstream divisions.

The second string to Shell's reformation lies in a US$30 billion divestiture program which, apart from raising cash, is intended to bring debt to very low levels and will simplify the overall group. The company forecasts US$20 billion a year in free cash flow by 2020 on the basis of an oil price of US$60 per barrel, capex of US$25-30 billion p.a. and a free cash flow yield of 13% p.a. – more than enough to meet the current 7% dividend yield. On current forecasts, which we believe to be highly conservative, the cash dividend is covered at an oil price of US$52 per barrel. As the market re-appraises the sector, it is highly likely that the strength that Shell has in traded LNG, conventional and deep-water production as well as the downstream initiatives will result in a significant re-rating. A higher oil price is not a precondition for this to be a fine investment.

## Outlook

We do not have very strong views about markets at present. We can see plenty of areas that are already pricing in a lot of promise, but equally, we are finding enough areas of neglect to keep us very busy.

**Interest rates are evidently rising** in the US with the paradox that so long as there is uncertainty around the US legislative process, the desire to tighten faces hesitancy. However, the bond markets have been signalling the rising trend since last year and improving trade numbers around the world reinforce the conviction about global growth.

The other area that has been plaguing confidence is concern around the tightening of credit in China. As we alluded to earlier, **a reallocation of credit within the system can ameliorate this reduction** in the growth rate of credit. What heartens us greatly is the rise in the prices of formerly oversupplied commodities within China, implying that the forced removal of surplus capacity is proving successful. Prices of steel, cement and float glass have respectively risen by 75%, 30% and 16% from this time last year. With strong profit growth reflecting this improved pricing power, think how this improves **the loan books of the Chinese banks**.

The prospect of more balanced global growth and capital flows should continue to favour our portfolio.

## Disposition of Assets

| REGION | 30 JUN 2017 | 31 MAR 2017 |
|---|---|---|
| Asia | 34% | 35% |
| Europe | 19% | 21% |
| North America | 17% | 18% |
| Japan | 16% | 16% |
| Russia | 1% | <1% |
| South America | <1% | 0% |
| Australia | 0% | <1% |
| Cash | 13% | 10% |

Refer to note 2, back cover.
Source: Platinum Investment Management Limited.

## Top 10 Holdings

| STOCK | COUNTRY | INDUSTRY | WEIGHT |
|---|---|---|---|
| Samsung Electronics | Korea | IT | 3.5% |
| Alphabet Inc | USA | IT | 3.1% |
| Lixil Group Corporation | Japan | Industrials | 2.4% |
| Tencent Holdings | China Ex PRC | IT | 2.3% |
| Oracle Corporation | USA | IT | 2.2% |
| Kering | France | Consumer Disc | 2.2% |
| Inpex Corporation Ltd | Japan | Energy | 2.0% |
| Sanofi SA | France | Health Care | 2.0% |
| PICC Property & Casualty Co | China Ex PRC | Financials | 1.9% |
| TechnipFMC | UK | Energy | 1.9% |

As at 30 June 2017. Refer to note 3, back cover.
Source: Platinum Investment Management Limited.

For monthly updates of the Fund's invested positions, including country and industry breakdowns as well as currency exposures, please visit www.platinum.com.au/our-funds/platinum-global-fund/#MonthlyUpdatesForThePlatinumGlobalFundPGF.

# Facts, Feelings and the Importance of Composition

**by Kerr Neilson, CEO**

Among the gifts of the Internet is the ability to gain access to almost **inexhaustible flows of information**. It can be a blessing to analysts who are trying to become familiar with a new industry or process. For example, when we were examining aspects of a new chip design affecting Intel, we were able to attend remotely a course run by a well-respected university on some of the technical issues that impinge on the semiconductor manufacturing process. This was available on YouTube. The drawback to this access to world-wide information and knowledge is that it can also give one a **false sense** of knowledge, a false sense of control.

The Internet also results in one being bombarded with news and viewpoints, and some may be inclined to respond to this deluge by using heuristics and relying on gut feel to cope with the overload. The alternative may be to read only those sources of information or news that accord with one's own comfort zone.

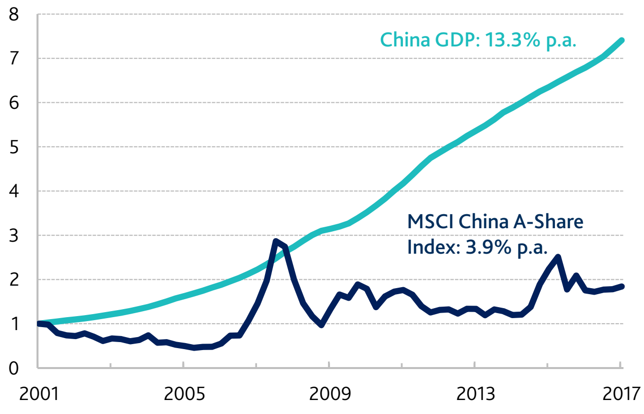
Let's take a concrete example of how **news can be nuanced**. Consider what constitutes news, who chooses the headlines, what or who prioritises what we see or read. For example, weather patterns are presumably far more interesting to a drought-stricken farmer than an urban millennial. And even when it has been determined what should be transmitted, there is still the need to understand the **perspective of the reporter** or the editor.

Think of yourself as a reporter for CCTV, China's national broadcaster. In view of the national admission that China can no longer guarantee food self-sufficiency for its 1.3 billion inhabitants, how would you report on China's behaviour in one of its critical supply routes, the South China Sea? Protection or aggression? By contrast, a Washington-based reporter may see matters from a completely different position and report the same events as a demonstration of the territorial ambitions of a new hegemon.

Let's now turn to the purpose of this note. **Some may believe that the stock market directly reflects the health of the economy**, that there is a tight correlation between an economy, profit growth and the stock market. **Academic studies show that there is virtually none** – though this may still leave many sceptical! Take for example the Chinese domestic market, despite the economy growing feverishly at an average annual rate of 13% over the last 16 years, magnifying economic activity by more than sevenfold over that time, the stock market has risen by only 1.8 times.

**China GDP vs. MSCI China A-Share Index**

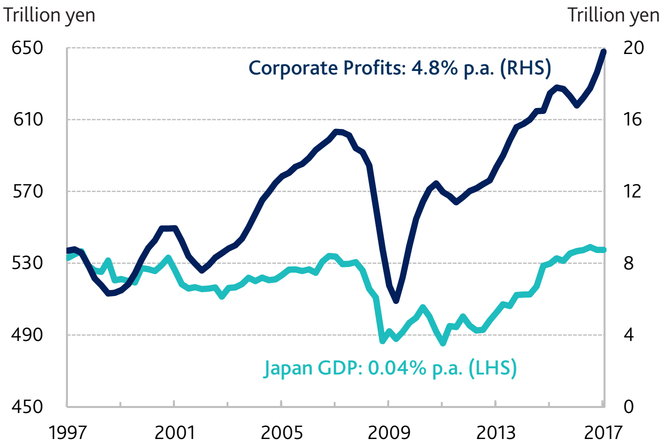
Index, March 2001 = 1




Source: FactSet, Platinum Investment Management Limited.

Consider also the experience of the Japanese market. The Japanese economy has grown very little over the last 20 years, yet corporate profits grew by nearly 5% per annum since June 1997. Stranger still, Japan's stock market for the most part was in chronic decline over the same period. Incidentally, with a falling population, real GDP growth per head in Japan has not been so different from that of the USA over this period, at 1% per annum.

**Japan GDP vs. Corporate Profits**




Source: FactSet, Platinum Investment Management Limited.

| Q1 2002 TO 30 JUNE 2017 (4Q AVERAGE) | STOCK MARKET PERFORMANCE (USD) | GROWTH | | VALUATION | | PROFITABILITY | |
|---|---|---|---|---|---|---|---|
| | 15 yr p.a. | Earnings per share (EPS) 15 yr p.a. | Book value per share (BPS) 15 yr p.a. | Current forward price-to-earnings (P/E) | 15 yr average forward P/E | Current return on equity (ROE) | 15 yr average ROE |
| World | 7% | 6.4% | 5.0% | 18 | 15 | 10% | 12% |
| North America | 8% | 6.1% | 6.0% | 22 | 18 | 13% | 14% |
| Western Europe | 7% | 4.6% | 4.5% | 20 | 15 | 10% | 12% |
| Asia ex Japan | 11% | 9.9% | 7.3% | 17 | 15 | 11% | 13% |
| Japan | 5% | 16.4% | 4.7% | 17 | 18 | 8% | 8% |
| India | 15% | 8.7% | 8.9% | 24 | 17 | 12% | 17% |
| Greater China (China, Hong Kong, Taiwan) | 12% | 10.8% | 7.7% | 16 | 16 | 11% | 13% |

Source: FactSet, MSCI Inc, Bloomberg.

The above table tends to cement the argument that our **impressions are often very different from the underlying facts**. In aggregate, earnings across the globe have grown by around 6.4% a year over the last 15 years (somewhat higher than the 100-year nominal average). Earnings growth among Japanese companies (16%) has far outshone that of investors' favourite, India (9%), and yet the Japanese stock market has been a sad laggard.

Clearly, time frames matter for this type of exercise. For example, though the Japanese market has lagged, if one focuses only on the last five years, it looks far better, having doubled in a strong burst off the bottom in mid-2012.

For all the talk of a dysfunctional Europe, European shares have nevertheless risen faster than earnings. This is explained partly by the relatively low valuations back in 2002, and the subsequent lift in prices. Either way, the link between stock market moves and earnings is far from precise.

Earnings forecasts can be just as rickety. Back in 2008, optimistic analysts were forecasting the S&P 500 Index to earn over US$100. We nearly got there several years later, and only now, with the aid of possible tax cuts and furious share buy-backs, is the S&P 500 Index likely to earn US$130. Yet, the stock market is up 58% from the 2008 peak.

The table also shows that Asian shares have risen faster than their earnings with the consequent re-rating showing in the rise in the price-to-earnings (P/E) ratio.

***How often do you check whether your "feelings" are backed by facts?***

For all their experience, fund managers are also prone to being influenced by impressions and the prejudice of stale information or an out-of-date understanding of a company's status. One way of reducing and coping with the complexity is for fund managers to concentrate on the principal companies within a large index. This is rather less challenging than trying to pick the eyes out of, say, the 6000+ listed entities that have a market capitalisation of more than US$1 billion, which is the Sisyphean endeavour we have tasked ourselves with here at Platinum.

The approach favoured by the majority tends to lead to portfolios that mimic the underlying index as these managers over-weight here or under-weight there, so-called "index awareness" or "**index–hugging**". Alternatively, if a manager's style is driven by news events, they may have a tendency towards **momentum investing** and bet on the latest hot topic: lithium, autonomous driving, artificial intelligence, you name it.

We at Platinum try to eschew both these approaches with **our contrarian style** which is **augmented by solid quantitative analysis**. One needs to inculcate independent thinking and use tools to assess when there is a wide divergence between "feelings" and the underlying data.

This leads to the essence of this note – **how does the weight of evidence compare with the strength of conviction**.

Essentially we are verifying the strength of our emotional conviction against the strength of the evidence underpinning it. When does one feel over-confident and when is more conviction warranted? The importance of this matrix in markets is quite unlike that of a personal exchange of opinions. In stock markets, indeed in markets in general, there is the extra dimension. **That dimension is price**, and it changes with information flow, fashion and other very human frailties. It is almost certain that the day-to-day volatility of a company's share price bears little correlation to the real changes in the intrinsic value of the business!

Having a hunch about the weather or some other matter may not be threatening, but in markets "feelings" matter because they pertain to the ***price*** at which one transacts.

Do the feelings match the realities, or are market participants acting with **availability bias, anchoring, framing or other heuristics that individuals subconsciously use to simplify their choices**? Should short-term considerations, which in the moment can seem so blindingly certain, form an important part of the decision?

To apply this **matrix** to the real world, let's cast our mind back to early/mid 2016. The over-riding fear about negative interest rates, weak growth, the over-supply of commodities, banking fears in China, the solvency of the European banks and so on was all-consuming, so much so that to most people it seemed at the time that these issues could not possibly be transitory.

**A Matrix of Facts vs. Feelings**

| | WEAK EVIDENCE | STRONG EVIDENCE |
|---|---|---|
| LOW CONVICTION | • Mid-range companies<br>• Neither great price-makers nor price-takers<br>• Moderate growth<br>• Average valuations | • Commodity producers in early 2016<br>• Perceived as weak businesses<br>• Little regard shown to producers low in the cost curve<br>• Prices relative to replacement cost at decade lows |
| HIGH CONVICTION | • Consumer packaged goods companies in mid-2016<br>• Virtually no inherent profit growth<br>• Well above average valuations<br>• Trend followers accentuate over-valuation | • "FANG" stocks (Facebook, Amazon, Netflix, Google)<br>• Strong and persistent growth<br>• Qualities recognised with high valuations<br>• Highly crowded institutional ownership |

At that time the market was **fixated on avoiding uncertainty** and investors favoured companies that they "knew" would grow (conviction) and, indeed, had every likelihood of continuing to grow as they had done since their inception (evidence). The so-called "FANG" companies (Facebook, Amazon, Netflix, Google) were much in demand and this showed in their high valuations (***high conviction/strong evidence***).

In sharp contrast, **commodity producers** were the companies that investors loathed with a visceral fear, accentuated by the prevailing uncertainty. This was so despite the baseline logic that low commodity prices would clear away high cost supply and in due course allow lower cost producers to earn at least a modest return on assets – demand was not in contention. At that time commodity producing companies were selling at valuations previously seen in the depths of despair of the post-Lehman carnage. The logical case to own them was strong, but the conviction was pitiful (***low conviction/strong evidence***).

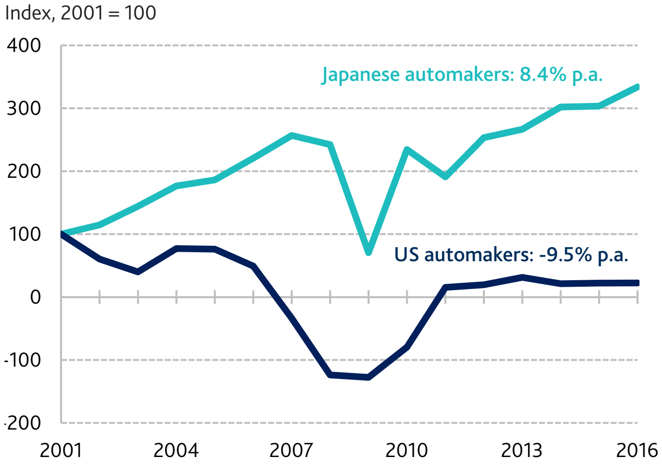
The other area that was attracting investors in early/mid 2016 included ***high conviction/weak evidence*** companies such as consumer packaged goods producers, like Kellogg's, Colgate-Palmolive, The Campbell Soup Company, and General Mills. Here was a group of companies that had barely seen any sales growth for several years, but through various devices were sustaining their profits or lifted their EPS, and this met the prevailing need for certainty, almost regardless of price. We contend that these companies should be classified as "weak evidence" because they were being priced well above the average (with P/E ratios above 20 times) while achieving EPS growth that barely matched the average company.

The last group – the ***low conviction/weak evidence*** companies – were left to their own devices and satisfied neither optimists nor pessimists. Our quantitative model will generally steer us away from these candidates. Priority is given to the first two groups where there is **dissention caused by fear or greed**.

Another common error made by investors as they participate in the daily battle to find opportunities is that of **composition**. The general should not be mistaken for the specific. We have for a long time argued that the Japanese stock market is refulgent with opportunity. Invariably, we are reminded by the interlocutor of the aging population and, when we skilfully evade that ambush, are parried with the many other imperfections that investors would rather not expose themselves to. The fact that the market has more than doubled off a 35-year low carries no weight among the doubters, as their conviction, shaped largely by news headlines, carries them blithely along with the crowd. The point that we are able to buy international corporations that simply have their headquarters in Japan and most of their business and assets abroad is conveniently ignored.

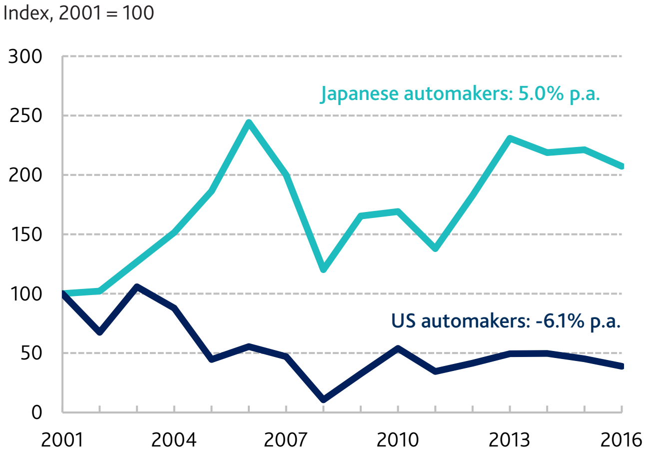
So let's look at the particular. The accompanying charts on the next page illustrate the aggregate performance of two pairs of leading car companies, Toyota and Honda on the one hand versus Ford and GM on the other. For simplicity, we have created a composite number to represent each pair's **growth in sales, profit and book value per share** over the

### Japanese vs. US Automakers' Earnings Growth




Source: FactSet, Platinum Investment Management Limited.

### Japanese vs. US Automakers' Share Prices




Source: FactSet, Platinum Investment Management Limited.

last 15 years. These are numbers generated after taking into account all of those headline-grabbing issues, varying from product recalls and consequential excruciating fines to Japan's supposedly sleepy management.

Evidently, the difference in share price performance has been night and day. The lesson again is to rely on a baseline numeric assessment rather than the far less reliable yardstick of one's intuition. Here we have a classic extension of the same problem described earlier where general impressions can corrupt clear judgment. Even though the host markets were very different, the opportunities given by these Japanese auto companies were just shy of those available from world markets over the last 15 years, viz 5% p.a. for Japan versus 7% p.a. for the MSCI All Country World Index in USD terms!

Mind you, **this is not a one-off**. Take China today, overall the market may not be so interesting, particularly if one pays heed to the press about all the careless lending and state-sponsored capex. All are reasonably accurate, but the question that needs to be asked is where the opportunities lie, and whether the bad lending does anything to diminish the prospects of those attractive companies. Chinese banks will in all likelihood have large bad loan write-offs, which will likely impair their equity. However, they won't be taken in one hit. Rather, the bad loans may be tantamount to writing off a good part of the next five years' earnings. The question that interests us is **where else in the world one can buy insurance companies that are growing at 10 to 15% p.a., yielding 3 to 4%, are priced at 1.5 times book value and less than 15 times earnings**. Recall that the global P/E average is now 18x while historic EPS growth rate is under 7% per annum. The market's general aversion to China has allowed us to own some marvellous consumer companies like liquor-maker Moutai, which we have recently sold after a huge run, regardless of the fears about the economy.

The experience in India has been very different. Local investors are very active and companies that will benefit from rising living standards tend to be very enthusiastically priced. They have grown strongly, but with P/E ratios above 30, there is little margin for error. By contrast, one can own relatively slow growers among the utilities that have a promised return on assets, where earnings will grow with high probability and which sell on low teen P/E multiples. Our choice is to favour this **opportunity of composition** by owning the utilities rather than the more obvious high growth consumer companies.

In Europe, we had the same experience by owning the Italian banks which we believed were being tarred by availability bias, i.e. investors' attitude towards them were unduly influenced by feelings heightened by recent events.

There will be many times when there is high emotional conviction but weak factual evidence, and yet investors want to support these causes. The chances are that they are backing an index, because it *feels* safe, while in all likelihood they are falling into **the wrong quadrant in the matrix**.

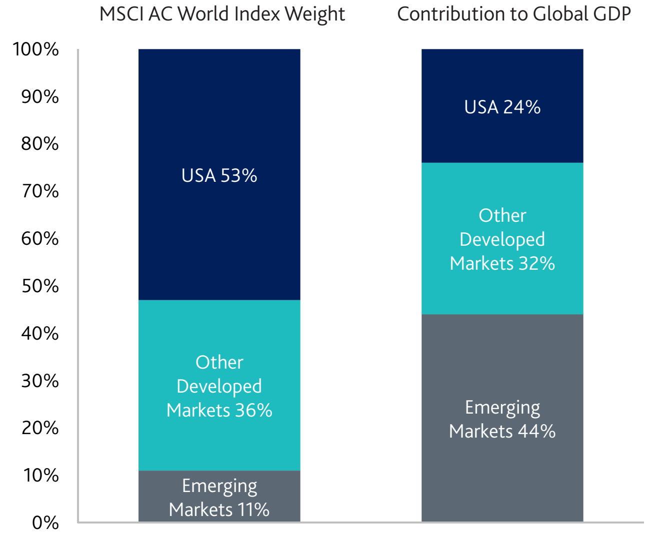
For those that find it challenging to deal with this paradox or with the ambiguity of markets, owning a global ETF may seem to be the solution, but it may run the risk of backing yesterday's winners. From our perspective, we believe there is a place for investors to apportion part of their assets to fund managers who are obsessed with the opportunities created by the imperfections in this matrix.

To conclude, today one might have the feeling that the US represents the best and brightest opportunity, but there are two snags with this.

Firstly, it is "over-indexed" in the MSCI (a term consumer product marketing companies use to denote a disproportionate market share versus market relevance). Secondly, the historical outperformance is approaching a significant extreme and we all live in the same round world!

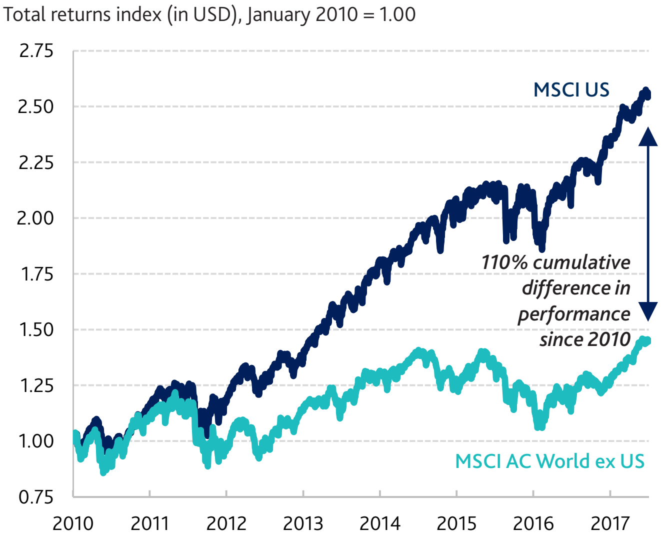
Do note that US GDP represents less than 25% of the global total, and even when adjusting for the reach of its highly successful multinationals, this variance in weighting is questionable. Our quantitative work suggests that there is no need for investors to have over 50% of their international share exposure in the US today, as would be prescribed by the "index-hugging" funds. Being a notable exception, the Platinum Global Fund has around 70% of its assets invested in Asia (including Japan) and Europe.

### The "Over-Indexing" of US Companies




Source: MSCI Inc, RIMES Technologies, World Bank.

### US vs. The Rest of the World – Can the Trend Continue?




Source: FactSet, MSCI Inc, RIMES Technologies.

# Macro Overview

## by Andrew Clifford, CIO

The focus in our last quarterly macro overview was on the massive imbalances in global trade that have arisen over the last 20 years. While China has been a well-known and recognised source of these imbalances, we noted that since the Global Financial Crisis, the Eurozone has moved from a small current account deficit to a surplus of over US$400 billion, and that South Korea has seen a fivefold increase in their surplus to US$100 billion. For comparison, China generated a surplus of a mere US$271 billion in 2016, having peaked at US$421 billion in 2008. What is important to remember is that when a country or region generates a current account surplus, these "excess earnings" (savings) are exported abroad and invested in other countries. Over the last two decades, the major recipients of these flows have been the US, the UK, Australia and Canada, who have benefited from this capital being invested in their real economies and financial markets – bonds, shares, and property alike. We think this pattern of trade and capital flows, which has been part and parcel of the global economy and financial markets, is set to change. In China, the ongoing strong growth in consumption spending, and in Europe a cyclical recovery, will result in lower current account surpluses and less capital exported abroad.

If this rebalancing is indeed underway, then we think there are potentially significant implications for Australian investors. Foreign capital inflows have long been a characteristic of the Australian economy. All of our investment cycles, whether it is the mining investment boom that is now coming to an end or the current cycle in residential apartment construction in the capital cities, have been in part funded by foreign money. At times foreign participation is clearly visible (as it has been in the case of property and mining), but it also plays an indirect and less conspicuous role via our debt markets and by funding our banking system. **There is nothing intrinsically wrong with this.** However, if the current account surpluses of the likes of Europe and China decline in the years ahead, we would be faced with a choice between:

1. saving more (and reducing our dependence on foreign money),
2. competing for our portion of a dwindling pool of funds by raising rates of return for investors (i.e. higher interest rates), and
3. experiencing a fall in our living standards via a fall in the Australian dollar.

If this occurs, it will come at a time when the Australian economy and markets are particularly vulnerable. We are hardly the first to make the observations that appear in the following paragraphs, and, indeed, the financial press has for some time been littered with predictions of a coming demise of our property market and, with it, our economy. We don't intend for this article to be another "bell ringing" prediction of an Australian property market collapse, though we do not discount this as a possibility.

The indebtedness of Australian households has been rising steadily over the last two decades and now stands at 189% of household income, high by global standards and ranking us fourth in the world. Of course, this has been brought about by ever falling interest rates. Nevertheless, it leaves Australian households vulnerable to either higher interest rates or falling asset prices, if and when either of these events occurs. Falling interest rates and expanding household debt have clearly been a driver of residential property prices across much of the country. A global study of property prices conducted in late 2016 shows that Sydney property prices were 12.2 times the medium household income (up from 7.6 times in 2004), making it the second least affordable property market in the world after Hong Kong.[1] Melbourne, at 9.5 times, is ranked the sixth most expensive market globally. That Australians are highly indebted and our property prices are high is hardly news to readers, and indeed these observations could have been made for much of the last decade.

The other variable worth noting is the use of "interest only" (IO) mortgages. According to the Reserve Bank of Australia (RBA), 23% of "owner occupied" mortgages are interest only, up from mid-teen levels a decade ago.[2] For investment properties, 64% of mortgages are interest only, though this has been relatively steady for some time. There are numerous reasons for using interest only loans. For investment properties, it can allow negative gearing benefits to be maximised, and for home owners it provides flexibility in the rate of repayment and allows for a simple redraw of funds. However, compared with a principal and interest loan, IO loans also allow a borrower to access more funds than one might otherwise be able to. To get a sense of the role IO loans played in the US housing crisis, one can watch the movie *The Big Short*, or for a more in-depth understanding,

1 13th Annual Demographia International Housing Affordability Survey: 2017.

2 RBA Financial Stability Review, April 2017.

read the book of the same title by Michael Lewis. Recently there has been much focus on the regulatory changes limiting banks' ability to issue IO loans. The result has been an increase in the interest rates on IO loans relative to traditional principal and interest loans. Some commentators see this reduction in the availability of IO mortgages as well as the rise in the cost of these loans as the catalyst that will bring down the housing market. That may be so, but it is problematic to have any degree of certainty without much more detail on household finances. Nevertheless, the enthusiasm for IO mortgages certainly points towards a higher degree of speculative behaviour by property buyers than one might otherwise assume.

We think it highly likely that at some point the Australian property market will have some sort of setback, and that potentially along with it we will see significant distress in household finances and a significant jump in the credit costs of the banking system. However, as we have seen elsewhere, the catalyst for and timing of such crises are notoriously difficult to predict, and when they do occur, it can happen in an instant. And such events are not usually accompanied by numerous experts predicting their occurrence, as seems to be the case here (though we would caution readers not to take too much comfort in this). Trying to prepare oneself for an onslaught that may not happen for some time, or that may not happen at all, is difficult.

So what should Australian investors be doing? Our observation from meeting with many individual investors and their advisors is that there remains significant potential for Australians to increase their exposure to international markets. Not only will it have the benefit of significantly diversifying the "Australia risk" in one's portfolio, it also provides the added protection that a fall in the Australian dollar, which will likely accompany any calamity in the local property market, will add to the returns from offshore assets. Now you may be thinking, Platinum, as a manager of global share funds, of course would be saying this! Nevertheless, we do truly believe that there are investment opportunities beyond our shores, particularly in Europe and Asia, that are substantially more attractive than those afforded by the Australian market. I would encourage you to read the article by Nik Dvornak, ***Europe's Road from Austerity to Prosperity***,[3] in which he explores the experiences of the German economy and investor in contrast to those of the Australian economy and investor over the last 30 years. The paper provides valuable insights as to why we think now, more than ever, is the time for investors to head offshore.

## Outlook

Over the last 12 months stock markets in Asia and Europe have handily outperformed the US as economic recoveries have taken hold in China and Europe. In local currency terms, Europe gained 20%, Japan 30.5%, and the rest of Asia 25.6%, while the US returned 17%.[4] The result has been strong in terms of absolute returns across Platinum's full suite of funds which also achieved good relative returns in most cases.

After a strong year of performance across markets, and remembering that global markets have now delivered to Australian investors over 17% p.a. for five years, one should be more cautious about the year ahead.

In the US, the Federal Reserve raised interest rates in June, and has now raised rates in each of the last three quarters. Additionally, the Fed will start to reduce its holdings in US Treasuries and mortgage backed securities, acquired during quantitative easing. The issue is that monetary policy cycles tend to proceed until economic growth slows and stock markets decline. The combination of rising interest rates and the high valuations of US stocks is the main reason to maintain a relatively cautious approach to markets. With the federal funds rate at only 1%, it is tempting to assume it is still early in the tightening cycle, but given that we have already experienced additional tightening by the removal of quantitative easing, it is difficult to judge. Certainly markets appear to have shrugged off that latest increase, but at some point we will likely see a setback resulting from higher interest rates.

Asia and Europe, on the other hand, seem to be offering better opportunities. Despite their strong returns over the last year, our Asian and European investments are still showing a combination of attractive absolute valuations and underlying earnings growth, which we think will see these investments continue to produce good returns over the next three to five years.

During the quarter, one of the key developments has been the reform of the Chinese financial system where authorities have been enacting clearer regulations around securitisation and financial products (i.e. the so-called shadow banking system). These reform measures, if successfully implemented, are without question a very positive development for China, as the reckless use of credit has clearly been a key risk for the country's economy. However, we have seen credit growth slow very significantly, and the short-term concern is whether this tightening in credit will cut short China's recovery. While robust pricing of industrial materials such as steel, cement and glass suggests that all is intact for the moment, there will be swings and roundabouts in China's progress. Importantly, most of our holdings in China have at the core of the investment case a strong secular growth story and tend to be less dependent on the short-term growth factors.

3 Visit https://www.platinum.com.au/journal/views/europes-road-from-austerity-to-prosperity/

4 Respectively, MSCI AC Europe Net Index, MSCI Japan Net Index, MSCI AC Asia ex Japan Net Index, and MSCI US Index. Source: RIMES Technologies.

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## 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).

1. The Fund's returns are calculated using the Fund's unit price and represent the Fund's combined income and capital return for the specified period. They are net of fees and costs (excluding the buy-sell spread), are pre-tax, and assume the reinvestment of distributions. 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 the Fund's underlying assets and other risk factors associated with investing, investment returns can be negative, particularly in the short-term.

   The Fund's inception date is 8 September 2014.

   Index returns have been sourced from RIMES Technologies. Index returns include dividends, but, unlike the Fund's returns, do not reflect fees or expenses. Platinum does not invest by reference to the weighting of the MSCI All Country World Net Index (A$) (the "Index") or any other indices or benchmarks. The Fund's underlying assets are chosen through Platinum's individual stock selection process and, as a result, the Fund's holdings may vary considerably to the make-up of the Index. Index information is provided as a reference only.
2. Regional exposures represent the Fund's exposure to any and all company securities and long derivatives (of stocks and indices) as a percentage of the Fund's net asset value.
3. The table shows the Fund's top ten long stock positions (including company securities and long derivatives) as a percentage of the Fund's net asset value.
4. The table shows the Fund's major net currency exposures as a percentage of the Fund's net asset value.