



Platinum  
Global Fund<sup>®</sup>

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Quarterly Investment  
Manager's Report

31 December 2015

# Platinum Global Fund



**Kerr Neilson** Portfolio Manager

## Performance

(compound pa, to 31 December 2015)

	QUARTER	6 MTHS	1 YEAR	SINCE INCEPTION
Platinum Global Fund	3%	-2%	8%	13%
MSCI AC* World Net Index	1%	0%	10%	16%

\* Morgan Stanley Capital International All Country

Source: Platinum and MSCI. Refer to Note 1.

The failure of the Organisation of the Petroleum Exporting Countries (OPEC) to arrive at any production restraint as well as the realisation of weaker demand in the face of greater supply set the tone for a massive capitulation of the commodity basket. One can trace the shift in sentiment from one of wishing to take advantage of potential bounces to resignation that it may be a long bottoming process. This deterioration in sentiment washed across the high yield (risky corporate bond) market where prices collapsed. As in the equity market, the pricing differentials of the seemingly 'safe' CCC-rated commercial paper from that which has pure commodity price exposure, and hence greater uncertainty, is unusually large. This is interesting as defaults are still low and bankruptcies still rare. The problem lies in the markets being unusually illiquid on account of the investment banks vacating the position of market-makers in the aftermath of the introduction of the Volcker Rule on balance sheet gearing. For example, energy companies are about 15% of the total high yield market. As their bond prices went down, the rest of the market was dragged along as investors tried to hedge

their exposure as well as they could, either via exchange traded funds (ETFs) (e.g. HYG and JNK) or through credit default swap indices (e.g. CDX). The HYG high yield ETF is off 14% from its February high, but this masks the underlying damage to the prices of some issuers.

Among equities, anything with a high level of debt has been hit hard. Moves of 50% or more were not uncommon. Master limited partnerships (MLPs) were one of the obvious targets, but certainly not the only ones. Old corporate titans such as Freeport-McMoRan, Chesapeake, Kinder Morgan and HCA are down anywhere from 30% to 70% from very recent highs in the year. Other high profile companies such as SunEdison, Tenet Healthcare, Frontier Communications and Sprint are also down substantially. We have been warning for some time about the dangers of ultra-cheap money and its corrosive effect as investors reach for yield. MLPs epitomised this danger with structures that give their general partners incentive distribution rights (IDRs). These encourage an increase in leverage, but the real damage was done by the increasingly exposed commercial risks built into the marginal assets purchased.

Otherwise the narrowness of the US market in particular has been a highlight. Strength has been confined mostly to 'FANG' stocks (Facebook, Amazon, Netflix and Google) plus a limited group of others such as Electronic Arts, Home Depot, refiners, cloud computing stocks and housing. A lot of sectors are in the middle of bear markets: industrials, transports ex airlines, media, mining and anything to do with energy. Despite this, the S&P Index hovers around the highs on earnings that have been well below (-15%) those expected at the beginning of 2015 which was US\$127.

Draghi meanwhile provided plenty of reassurance that quantitative easing (QE) is here to stay, which led to the Euro being among the very crowded, and therefore vulnerable, trades.

The Chinese equity market seemed to have stabilised towards year-end and the general consensus is that we are on the way to a soft economic landing and a gradual depreciation of the Chinese yuan. Life was less pleasant for those emerging markets that have wasted the resource boom and failed to bring through economic reforms with the likes of Brazil, Russia, Turkey, South Africa, Malaysia and Indonesia all suffering investor defections. They carry a litany of ailments from current account deficits, dependence on commodities, political issues, high interest rates and rising inflation – a relative rarity these days.

It has yet again been an eventful year with plenty of opportunities to win or lose. Given our investment approach and the pitfalls this can create in a winner-takes-all type of market, our performance is acceptable. For the quarter and the year, the Fund achieved respectively 2.5% and 7.9%. This compares with 1.4% and 9.8% respectively for the MSCI AC World Net Index (A\$).

### MSCI World Index Regional Performance (AUD)

REGION	QUARTER	1 YEAR
<b>Developed Markets</b>	<b>2%</b>	<b>12%</b>
<b>Emerging Markets</b>	<b>-3%</b>	<b>-4%</b>
<b>United States</b>	<b>3%</b>	<b>13%</b>
<b>Europe</b>	<b>-1%</b>	<b>9%</b>
Germany	4%	10%
France	-2%	12%
United Kingdom	-3%	4%
<b>Japan</b>	<b>6%</b>	<b>23%</b>
<b>Asia ex Japan</b>	<b>0%</b>	<b>2%</b>
Korea	2%	5%
China	0%	4%
Hong Kong	2%	12%
India	-4%	6%
Australia	6%	1%

Source: MSCI

### MSCI World Index Sector Performance (AUD)

SECTOR	QUARTER	1 YEAR
Information Technology	5%	16%
Health Care	3%	20%
Industrials	2%	9%
Consumer Staples	2%	18%
Consumer Discretionary	1%	17%
Telecommunication Services	0%	10%
Financials	0%	6%
Materials	0%	-6%
Utilities	-2%	3%
Energy	-4%	-12%

Source: MSCI

### Currency

We followed through with reducing our exposure to the US dollar in favour of the Euro and the Yen which are now highly competitive and were crowded shorts. We have also taken most of our cash back into Australian dollars on the basis of a possible bounce in commodity prices that have fallen to approximate fair value. Over the longer term, the Australian dollar may weaken further as currencies have a tendency to over-shoot. In addition, our current account continues to deteriorate.

CURRENCY	DEC 2015	SEP 2015
US dollar (USD)	50%	74%
Japanese yen (JPY)	12%	2%
Hong Kong dollar (HKD)	9%	7%
Euro (EUR)	9%	9%
Australian dollar (AUD)	9%	2%
Indian rupee (INR)	5%	2%
Chinese Renminbi (CNY)	-9%	-9%

Source: Platinum

### Geographical Disposition of Fund Assets

REGION	DEC 2015	SEP 2015
Asia	33%	34%
Europe	20%	23%
North America	19%	18%
Japan	12%	9%
Russia	1%	1%
Cash	15%	15%

Source: Platinum. Refer to Note 2.

### Changes to the Portfolio

There have been four significant additions to the portfolio and to pay for these we cut positions in Alphabet (formerly known as Google), Carnival Corporation, KEPCO, Mediobanca, KBR and Corning. In the case of the first four, their share prices had each run strongly and, while they remain great companies, valuations are no longer so compelling as to warrant the size of our holdings. In the case of KBR and Corning, there has been a deterioration or at least a deferral of the underlying positive case.

The big four purchases were Rakuten, Eni, McDonald's and Coca-Cola.

**Rakuten** is a pioneer in e-commerce in Japan. Its *ichiba* (meaning marketplace) site draws over 70 million registered users a year, with some 15 million purchasing on the site each quarter. The concept is to act as an aggregator by providing a **virtual mall** where retailers are hosted with the freedom to display as they choose, but where Rakuten, through the tracking of customer behaviour and checkout wallet, can offer merchants valuable insights. The key to their approach is to grant **loyalty points** to shoppers. Gradually, the company, under the flamboyant leadership of its founder and 40% shareholder, Hiroshi Mikitani, has added online travel services, banking, insurance and credit card businesses that are, because of the model, unusually profitable in a country not known for agile and globally competitive financial businesses. These alone account for 45% of profits.

By spending some US\$6.5 billion since 2002, Rakuten has assembled a portfolio of foreign e-commerce plays that troubles investors. **Ebates** is like an *ichiba*, but follows a cash-back approach that is much favoured by American online shoppers. It is growing fast, makes profits and will probably achieve a gross turnover of US\$5 billion this year. Others are incubators, with the likes of **Viber** which has over 620 million messaging users but is still to find ways to monetise. The other concern is the resurgence of the Yahoo! e-commerce site and the threat of Amazon, both of which are growing their business at least twice as fast as Rakuten's *ichiba* site. Our analysis gives the management the benefit of the doubt, given their history of turning around their foreign businesses and the kind of momentum that is being generated by Ebates in the US, with the hope of converting other national sites to the same cash-back format. As e-commerce businesses go, Rakuten is interestingly priced on 21 times the earnings of its Japanese businesses with optionality to realise value from its start-up portfolio and the monetisation of the likes of Viber.

**Eni S.p.A.** is our vehicle to participate in the eventual **tightening of the oil market**. It is the sixth largest listed integrated oil producer in terms of output, has a **rising production profile** and is adding to its reserves faster than the top five. It is arguably more cheaply priced than its global peers on account of a horrid history of being the Italian national champ and dumping ground.

This has been largely addressed and in the meantime the company has continued to have spectacular discovery success with the most recent Zohr field potentially holding over 30

trillion cubic feet (TCF) of gas off the Mediterranean coast of Egypt. It is within easy reach of its pipeline infrastructure, and for context, it nearly doubles Egyptian reserves and could supply the country, at current usage rates, for 15 years. As with other oil companies, there are nuances relating to the location of production, the oil/gas ratio, finding and extraction costs, etc. On balance, however, the equation is attractive and enhanced by a rising production profile where new projects have a break-even cost of US\$45 per barrel of oil equivalent (BOE). Like its peer group, Eni's production potential has admittedly fallen short of forecasts.

In the short-term, the share price will be driven by the crude price, but the company can generate strong cashflow profits at current prices to provide a 6% dividend. A discounted cashflow valuation suggests the peer group is factoring in a longer-term oil price of around US\$60 per barrel.

You may well think that we have joined the 'predictable' brigade by purchasing both **McDonald's** and **The Coca-Cola Company**. While these are slow-growing businesses that operate in a utility-like fashion due to their large competitive moats, they are not well-liked by the market and we see the potential for that to change as they deliver on cost reduction and sales growth initiatives. In the case of McDonald's, it already has a global footprint and the problem lies in moving with the market and keeping the franchisees, who manage 82% of the 36,000 outlets world-wide, profitable and motivated. This is a constant challenge as the typical McDonald's outlet already is the gold standard in terms of volumes processed (**US\$2,700,000 per annum versus some US\$1,700,000 industry average**) and coverage is ubiquitous.

The new management is doing interesting promotions like extending the breakfast offer throughout the day and there has been a make-your-own-burger initiative that has tested well in Australia and is now being rolled out globally. This company, like Coke, continues to face resistance from 'healthy eating', but we tend to see this as an evolution rather than anything more sinister and unlikely to displace the 69 million servings that the company's stores provide each day. We bought it when these concerns were starting to wane. It has subsequently provided about half of the 30% return we factored in at the time.

**Coke** may prove a more durable long. Here is a company that is trading at the **same price as 17 years ago**. (How often have you heard us emphasise the importance of price over prospect?) It has been grappling over this time with reconfiguring its many regional bottling agreements, now taking them back in-house and now farming them out to

specialist bottler groups. This process is ongoing, but consolidation in Europe and a new centralised framework for North America should see concomitant cost reductions through reform of the fragmented manufacturing base and thus higher future profits for both bottlers and The Coca-Cola Company. Further cost reductions come from actions to excise a portion of the corporate fat that almost inevitably accumulates in highly profitable organisations that have enjoyed long periods of dominance.

All of this is taking place against a backdrop of diminished demand for carbonated sweetened drinks (CSDs), different and changing preferences among consumers, notably in Asia, and a rise in bottled water consumption that has proved difficult to price with the same margins that have come from CSDs. For all that, **Coke still has brand supremacy** in most of its markets with drinks like *Coca-Cola* (in its now many varied sugared forms), *Fanta*, *Minute Maid*, etc. accounting for **21% of all bottled drinks sold annually world-wide**. This is indeed a formidable marketing machine, allowing it to **demand shelf space**. Finally, higher pricing is being achieved in the US, thanks to external pressure to reform the institutional culture that prioritised volumes and consequently bathed the American public in cheap *Coke* for generations. At times a 2 litre PET bottle was retailing for barely more than it was in the 19th century (then containing the arguable delight of cocaine), at about 5 cents per 6.5 ounce serving. Higher pricing and reduced promotions on large pack sizes are being complemented by a shift in sales volumes towards smaller servings, like the 200 mL aluminium cans that sell at a significantly higher price point and yet are leaping off the shelves. *Coke* has joined *PepsiCo* in embracing the idea that its product should be a treat in the form of a sparkling delight which people are willing to pay for, rather than a cheap and obesity-causing staple. These moves on pricing and mix offset the impact of volume declines on sales and provide a boost to profits. At 22 times earnings, the share is not evidently cheap, and the 75% of earnings that come from abroad are being hindered by the strong US dollar. However, the likelihood of a recovery in profitability and resumption of growth in developing markets gives a strong starting prospect.

## Commentary

Some may find economic history boring, but without such understanding one can often underestimate the significance of current events. The point of reference here is that China in the last few years reached the incredible position of accounting for nearly a **quarter of annual global**

**investment**. This is totally unprecedented<sup>1</sup>. It has meant a vast increase in its industrial base to a position where, in some industries, China accounts for more than 40% of world output. There is now chronic oversupply, most notably in steel, cement, flat glass and aluminium. Capacity will be scrapped, but during this process of adjustment one can expect weak prices in these products as residual surpluses are directed to foreign markets. This has important implications for investors both in terms of relying on a reversion-to-the-mean (investment style) and the type of companies they should be favouring. Magnifying the difference in the current environment from earlier cycles is the impact of e-commerce and its reconfiguration of so many business structures. This in itself is creating new or alternative supply at the cost of the incumbents. Yes, it is a difficult investing environment, but before dumping your positions, consider the important variable of **composition**.

Instead of segregating the markets into good and bad, we try to understand the environment and find those companies that can grow and which are not priced to perfection.

We would crudely summarise the global outlook thus:

- **Slow growth** but rising consumer incomes<sup>2</sup>.
- **Oversupply** of most commodities, but a gradual tightening of the hydrocarbons market<sup>3</sup>.
- **Weak pricing power** for most producers of 'things', as opposed to services<sup>4</sup>.

1 At the height of its economic power in the early 1950s, the US accounted for about 27% of world output of which *investment* represented no more than 5%. Even during the Ming dynasty, when China's economy might have represented 30% of world output, investment ran at relatively low levels.

2 Expectations are for world growth to be 3–3.5% in 2016 with gradual improvement in employment in so-called developed markets.

3 Like other metal and minerals, hydrocarbons are selling well below marginal cost with the distinction that shale sourced liquid and gas production require constant development expenditure which at current prices will see the output by North American producers slip by, say, 1 million barrels per day by mid-2016. Consumption continues to grow by about 1 million barrels per day and, by the second half of 2016, there is the prospect for tighter markets.

4 Plentiful supply of most manufactured goods, greater price transparency and convenience caused by e-commerce, plus an environment of small price increases, leads to a greater willingness by customers to shop around.

- **Low inflation** will keep **money cheap**, leading to a risk of misallocation (poor investment decisions)<sup>5</sup>.
- Continuing **substitution** caused by e-commerce<sup>6</sup>.
- **Currency** exchange rates that assist or impede profitability<sup>7</sup>.

One might think the above seems like an action-replay of 2015! It may well be, except one senses that labour and currency may squeeze corporate profits in some markets, and high valuations leave little room for earnings disappointments. One might make the case to buy some of the cyclicals that have been decimated as investors cast them out in their **search for certainty**, but apart from a strong short-term rally, we suspect they will face a relatively protracted downturn. In other words, mean reverting investment strategies may be unrewarding for a while yet. Anchoring to past high prices may also be misleading because of earlier valuation over-shoots relative to long-term value.

To give you some sense of the portfolio's composition, we can broadly categorise it as follows:

Old world (manufacturing, engineering services, utilities, commodities)	21%
New world Internet-based services	16%
Financials (mostly European and Asian banks and insurers)	14%
Consumer goods and services	14%
Information technology facilitators	12%
Health care (mostly big pharmaceutical companies)	8%
TOTAL LONG	85%

Within the 'old world' there are investments in Asian utilities, a smattering of Japanese manufacturers, global engineering companies and commodity producers. There are some global brand names among **the consumer plays** such as Coke, McDonald's, Carnival, and the luxury brands of Kering (e.g. Gucci), while exposure in Asia is to Chinese drinks companies and gaming shares.

<sup>5</sup> While there seems to be some wage torque developing, most notably in the US, in general the effect of weak commodity and energy prices combined with modest demand tends to dampen a rise in prices.

<sup>6</sup> The airing and sharing of e-commerce, with phenomena like Uber and Airbnb, is mobilising under-used capacity and causing significant disruption to traditional providers like hotels, cabs and delivery services.

<sup>7</sup> This has been one of the causes of earnings disappointments on Wall Street in 2015 and the big unknown is whether the US dollar will behave as it has during earlier tightening cycles and begin to weaken or whether QE in Japan and the Euro zone and the partial floating of the Chinese yuan will produce a different pattern this time around.

The most promising in terms of growth are the **Internet-based service companies**. These include the likes of Alphabet, Baidu, Tencent, Sina, etc., all with hearty growth rates. However, advertising spend in China is growing faster than in the West and the opportunity may lie in lagging monetisation where Chinese online advertising, at around US\$22 billion in 2015, is about a third of US levels. These companies derive a fair degree of protection from their scale and the structure of e-commerce in China and, in the case of the valuation of Baidu and Sina, there is reluctance on the part of investors to pay for their full potential because of the dip in earnings caused by the monetisation strategies being followed.

Under the heading of **information technology facilitators** we harbour the old suspects like Intel, Cisco, Oracle, Ericsson and Level 3 Communications. These are being treated as slow-growing dull stocks, but in our view are great value and unlikely to be dispossessed in the foreseeable future.

## Outlook

The fierce sell-down of a broad range of commodities and markets in the fourth quarter of the year ensures that the loneliest shepherd in Tibet has probably realised there are a glut of supply and dull demand prospects: in other words, any surprises to the positive will probably support at least a bounce.

The world is growing, albeit slowly, company profit prospects are not universally bleak, particularly in a world where there have been major currency re-alignments. As the vanguard of this credit cycle, the US bears the cost of a strong currency versus significant trading competitors in Europe and Japan and suffers now from a weakening Chinese yuan. Valuations, too, are not universally high and, as you know, we have high conviction in a group of strong Asian-based companies that are priced at absolute and relatively low valuations.

Our blend of assets across the portfolio encourages us to believe that we will achieve positive returns in the coming year.

### Kerr Neilson

Managing Director

Platinum Asset Management

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## Notes

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The inception date for the Platinum Global Fund was 8 September 2014.

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

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