MLC-Platinum Global Fund

QUARTERLY INVESTMENT MANAGER'S REPORT

PERFORMANCE

Fund Size: $961.2m	Last quarter	Last 12 months	5 years (compound pa)	Since inception (compound pa)
MLC-Platinum Global Fund	6.6%	21.0%	16.8%	11.2%
MSCI All Country World Net Index (A$)	3.7%	15.3%	17.1%	6.7%

Source: MLC Investments Limited, Platinum Investment Management Limited, and RIMES Technologies. Past performance is not indicative of future performance. The value of an investment may rise or fall with the changes in the market.

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 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!

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.

Platinum ASSET MANAGEMENT

MLC

MLC-Platinum Global Fund

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 6.6% for the quarter and 21.0% for the year, compared to 3.7% and 15.3% respectively for the Index. Over the last five years, the Fund has given investors 16.8% p.a. which is in line with the MSCI, even though our average net invested position has been around 85% or less.

FUND'S DISPOSITION OF ASSETS (NET INVESTED POSITION)^

Region	30 Jun 2017	31 Mar 2017
Asia	35.0%	34.9%
Europe	20.6%	22.8%
Japan	16.3%	15.8%
North America*	7.7%	10.4%
Russia	0.6%	0.6%
South America	0.4%	0.0%
Australia	0.0%	0.8%
Cash	19.4%	14.7%

Source: Platinum Investment Management Limited

^ The net invested positions represent the Fund's exposure to company securities and both long and short derivatives as a percentage of the Fund's net asset value.

* At 30 June 2017, the Fund had a short position in the US against the S&P 500 Index of -9.0% (31 March 2017: -8.0%) and a position against the Russell 2000 Index of -1.0% (31 March 2017: -1.0%).

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. We eliminated most of our long AUD positions on the expectation of a stronger US dollar following the tightening by the Fed (a narrower interest rate differential). However, the US dollar did not respond as much as expected. We also sold down the Korean won into strength against the US dollar and added to the Yen and the Euro. It wasn't our best quarter for reading currencies.

FUND'S CURRENCY EXPOSURE

Currency	30 Jun 2017	31 Mar 2017
US dollar (USD)	33%	17%
Euro (EUR)	16%	14%
Hong Kong dollar (HKD)	11%	10%
Japanese yen (JPY)	8%	5%
Norwegian krone (NOK)	8%	8%
Korean won (KRW)	6%	9%
Indian rupee (INR)	5%	6%
Australian dollar (AUD)	3%	20%
Chinese yuan (CNY)	3%	3%
British pound (GBP)	2%	3%

Source: Platinum Investment Management Limited

TOP 10 HOLDINGS

Stock	Country	Industry	Weight
Samsung Electronics	Korea	IT	3.6%
Alphabet Inc	USA	IT	3.1%
Lixil Group Corporation	Japan	Industrials	2.6%
Tencent Holdings	China Ex PRC	IT	2.4%
Oracle Corporation	USA	IT	2.4%
Kering	France	Consumer Disc	2.3%
Sanofi SA	France	Health Care	2.2%
Inpex Corporation	Japan	Energy	2.1%
KB Financial Group	Korea	Financials	2.0%
TechnipFMC	UK	Energy	2.0%

As at 30 June 2017. 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.

Source: Platinum Investment Management Limited.

Quarterly Report (Continued)

SHORTING

We added to index shorts as the quarter came to an end with an eye to heat coming out of the very extended tech sector rally.

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 **Alphabet (Google)**, **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. 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. We are working on each area for longs and shorts.

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.

Kerr Neilson
Managing Director
Platinum Asset Management

This report is intended to be read in conjunction with a feature article Kerr Neilson recently published on the importance of composition in portfolio construction.

Read the article, *Facts, Feelings and the Importance of Composition*, at www.platinum.com.au

MACRO OVERVIEW

by Andrew Clifford, CIO, Platinum Asset Management

The focus in our last quarterly macro overview[1] 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:

- saving more (and reducing our dependence on foreign money),
- competing for our portion of a dwindling pool of funds by raising rates of return for investors (i.e. higher interest rates), and
- 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.[2] 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.[3] 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, 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.

1 Available at https://www.platinum.com.au/journal/views/macro-overview/

2 13th Annual Demographia International Housing Affordability Survey: 2017.

3 RBA Financial Stability Review, April 2017.

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*,[4] 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%.[5] 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.

[4] Available at https://www.platinum.com.au/journal/views/europes-road-from-austerity-to-prosperity

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

If you have any questions about your investment in the MLC-Platinum Global Fund, please contact the MasterKey Service Centre on

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Platinum Asset Management is an Australia based international fund manager.
For greater insight into our process, please visit our website at *www.platinum.com.au*

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