



PLATINUM CAPITAL LIMITED

HALF-YEARLY REPORT

31 December 1997

Performance

The last three and six months have witnessed an astonishing divergence in performance of stock markets around the world. In the Far East, the markets of Korea, Indonesia, Malaysia and Thailand have seen their indices decline by 30-45%, which accompanied by currency depreciation, has translated into declines expressed in US\$ of 40-75%. This sort of wealth destruction has not been seen since the 1930s. By contrast, the western markets have tended to oscillate in a 15% band, accompanied by rising volatility and skittishness. The table below highlights the divergence in performance.

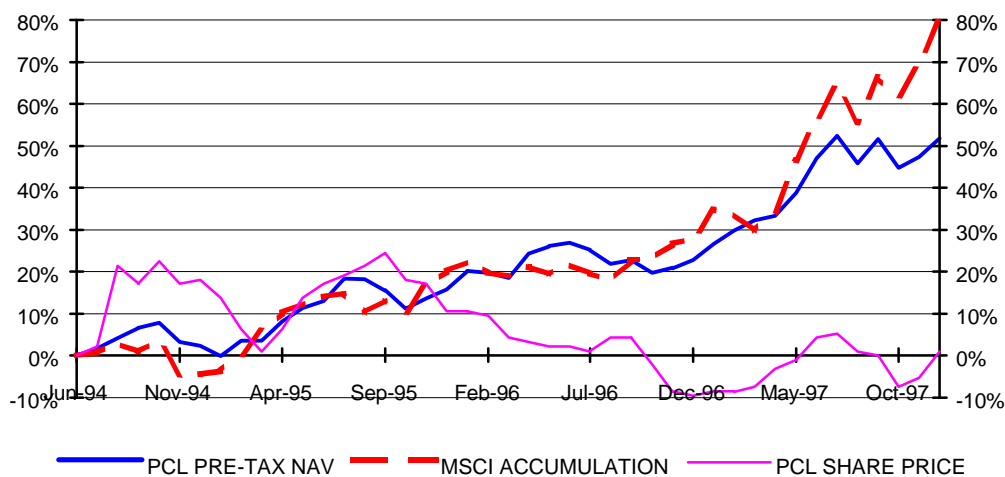
| MSCI (US\$) | 3 months | 6 months |
|-------------------|----------|----------|
| Far East ex Japan | -32% | -43% |
| Japan | -20% | -30% |
| US | +3% | +10% |
| Europe | 0% | +9% |

Concerns about valuations and signs of over exuberance have caused us to eschew most of South East Asia though we were trapped by the allure of low valuations of the Korean Samsung group of companies. The latter has held up well but the depreciation of the Korean won meant a significant fall in dollar terms. In Japan, our exporters (Fuji Photo Film, Canon) and highly profitable suppliers to the domestic market (Coca Cola bottlers, Asahi Breweries, Yamanouchi Pharmaceutical) have largely escaped the de-rating induced sell-off that was described in the September report. However, not even our stalwarts were immune to the pervading negative sentiment of the region.

The European companies in the portfolio have benefited from the consolidation of the financial sector with the likes of AGF (insurance) being bid for at 70% above our entry price of just three months ago, while BNP, Generali and San Paolo have all run strongly on consolidation considerations.

Valuation concerns persuaded us to maintain our portfolio hedging strategy in the States. However, the rise in the market over the second half of the year (+28% in A\$) clearly detracted from our performance. In South America, the concerns of the Asian contagion resulted in an abrupt sell-off in October, but since then, our Brazilian stocks have been gradually recovering.

In summary, the individual stocks in the portfolio have in aggregate outperformed their markets but the continuing short position in the US and the collapse of Korea are the culprits of our under-performance. These fully account for the differential between the MSCI (+16%) and ourselves (+3.2%).



PCL cumulative performance of NAV (pre-tax) and share price versus MSCI World Accumulation Index

Top Ten Holdings (as at 31 December 1997)

| Stock | Country | Industry | Holding |
|------------------------|-------------|------------------------|--------------|
| Rinascente | Italy | Retail | 4.4% |
| Fuji Photo Film | Japan | Photographic Equipment | 4.0% |
| Siemens | Germany | Electrical Engineering | 3.3% |
| Schindler | Switzerland | Lifts/Escalators | 3.0% |
| San Paolo | Italy | Banking | 2.9% |
| Swiss Industrial Group | Switzerland | Packaging/Engineering | 2.9% |
| Suez Lyonnaise | France | Water Utility | 2.6% |
| Nintendo | Japan | Home Entertainment | 2.6% |
| Yamanouchi Pharm. | Japan | Pharmaceutical | 2.5% |
| Canon | Japan | Office Equipment | 2.5% |
| Total | | | 30.7% |

Disposition of Assets

| Region | 31 December 1997 | 30 June 1997 |
|----------------|------------------|--------------|
| Western Europe | 38.9% | 31.9% |
| Japan | 27.1% | 31.8% |
| North America | 8.0% | 2.9% |
| South America | 6.7% | 5.6% |
| Other Asia | 2.8% | 11.0% |
| Australia | 0.9% | 1.1% |
| Eastern Europe | 0.4% | - |
| Cash | 15.2% | 15.7% |

Outlook

As we enter 1998, it is probably premature to believe the turbulence in Asia is over. Though much of the immediate damage has been revealed and indeed the shortcomings of credit allocation within Asia have been exposed by the markets,

there still remains the uncertainty of a period of declining economic activity and its resulting political consequences. The full effect of a co-ordinated effort by major banks to reschedule debt repayments should allow a return of stability to currency markets without which there lies the real prospect of significant dislocation. It will also be important to understand developments in China, where activity is sluggish and where stimulatory action will be required - hopefully not from a devaluation of the currency. From an investment stand point, we are inclined to let the dust settle before re-entering the Pacific Rim markets in a significant way.

Rather than diving headlong into these markets, we prefer the prospects and valuations of many Japanese companies. It is evident that economic growth will be fragile at best, but the stock market is pricing in just such a scenario as evidenced by the sell-off of companies that are sensitive to domestic demand (along with a gang of other companies that are simply being de-rated from the exalted valuations attributed to them during the theme-driven days of the bubble economy). There are now swathes of companies selling at around book value and indeed quite a few, admittedly with dull growth prospects, that are selling for less than their net cash value. In other words, one could retrieve the full purchase price simply from the repayment of cash on the balance sheet and still be left with the underlying business at no cost. Following the recent collapse in prices, our research has uncovered scores of companies that are selling at valuations last seen in the early Eighties (remember Japan has been in a bear market for eight years) and by our measures, are likely to give an internal rate of return varying between 10-30% compound. This work incidentally is based on a projected bond rate of 5% versus the current level of 2% and provides for relatively modest improvement in profitability over the next 4 to 5 years.

For those who think the country is a basket case, it is worth remembering that this is the largest economy after the US and it is largely self-contained with exports representing around 10% of GNP. Such is its savings and wealth creation, that it is the largest owner of US Government debt. That it is bound hand and foot by regulation is apparent to all, as is the present plight of its financial system.

Deregulation and change are gaining momentum. The tax structure is being overhauled, resulting in lower corporate and transaction taxes, and the finance industry is feeling the fierce winds of competition as the US investment banks have introduced their way of doing business. The Japanese companies we recently visited showed a keen awareness of the need for change. Some are now targeting profitability over market share alone, all are reviewing their employment and remuneration structures (issues of the seniority pay system; bonus for performance, etc), but most importantly, realise that their hitherto successful business model needs significant modification. This is an economy where companies are already familiar with the difficulties of living with falling prices, and even in this environment, the corporate sector, at still low levels of profitability, is a net generator of cash.

Despite pitiful returns on cash in the bank and in the bond market, Japanese investors are loathe to buy shares. Is now the time to capitulate to fear, or take heart, from the logic that good companies with sustainable growing businesses can look forward to a continuing weak yen abroad and improving pricing conditions at home? At worst, they will add to their inherent worth at between 6-10% per year with inflation likely to rise but still stay low. The very fact that our existing holdings have fallen by under 8% in the face of a market that has declined by 20% (in yen terms) since June, reinforces our view that indeed capitalism is returning to Tokyo. The market is recognising the superior qualities of the profitable growth companies and these have broken away from the dross as the bear market reaches its climax.

With our value orientated investment approach handicapping our ability to read the US market, we submit that Wall Street is providing little latitude for uncertainty. The threat to valuations, we believe, lies more with unpleasant earnings surprises than the prospects of interest rate rises alone. The supply of yen being created to stabilise the financial system in Japan and the imminent prospect of the formation of EMU on the one hand, keeps liquidity flooding, but equally it should pressure the US dollar further upward. This is not helpful for the foreign earnings translations or exports of US companies. Further, competition from Asian exports, which will now be intensified by weak home demand and the imperative to meet high fixed costs including debt (for those not bankrupted or taken over), will ensure that price competition in internationally traded goods intensifies. That the US market recognises this is evidenced by the recent relative performance of domestic orientated businesses such as retailers, newspapers and communications.

Even if the minimal inflationary environment allows long bonds to sag to yields of 5.5%, valuation models are hard pressed to reveal surplus returns from share ownership. Indeed, the Bank Credit Analyst assessment is that the US market is implicitly building in profit growth of 11% per annum for the next ten years to justify current levels. Real operating profits (as opposed to reported earnings) grew by only 5.5% in aggregate over the past five years. The only way to make the sums work is for further extraordinary improvement in productivity and/or aggressive share repurchase. Both are possible but have counter-productive implications. For those who gain comfort from the idea that there are no signs of excess in the US market, they might consider that if companies were to expense the cost of stock options just like any other form of remuneration, PEs would be considerably higher. From a technical point of view, it is also interesting to observe that stocks, as a percentage of household assets, either including or excluding pension fund assets, are back to the high point reached in the market peak of 1966 and this number incidentally is calculated before the exercise of outstanding options.

Having lost returns through our US hedging strategy, it is now very tempting to surrender and focus solely on our core strength of stock selection. However, the lessons of South East Asia, and Korea in particular, highlight the importance of the need for a clear overview in building a portfolio. Our methodology identifies areas of neglect and also those of exuberance. Flows suggest that most foreign investment managers have capitulated on the US. This is evidenced by the all-time record net additions in the third quarter at an annualised rate of \$94 billion. This together with the US market carrying a weight of nearly half in "the official investment universe"; the MSCI, make it hard to argue that this is a neglected market.

Valuations in Europe are not markedly lower than those in the US but we would argue that Europe is at an earlier stage of economic recovery and transformation. Profits are projected to grow at double digit levels over the next two years and with the abundance of resources freed up by deregulation and rationalisation, the threat of inflation is low. There are still resplendent opportunities for both regional and industry rationalisation as is already evident in defence, media, finance, etc and we have positioned ourselves to take advantage of this.

The big event this year will be the choosing of members for Monetary Union in May. As readers will appreciate from previous correspondence, the real dangers of EMU lie in the imposition of a fixed exchange relationship between members ahead of political and fiscal integration. Essentially, the reins of monetary and exchange rate policy are handed over to a new Central Bank with little, if any, compensating freedom to fine tune regional differences via fiscal policies. With a core (principally Germany and France) determining monetary policy (interest rates) and with little

need for any change in current levels of rates, there is a good chance for peripheral members experiencing conditions that prove highly stimulatory and which result in breakaway consumer growth. The one-size-fits-all approach in a continent with disparate sensitivity to interest rates, varying fiscal regimes and labour mobility impaired by language and cultural barriers, will create severe pressures early in the next century. However, this should throw up interesting investment themes in the meantime.

In Europe, we believe our stocks are well placed to continue to benefit from Euro integration and rationalisation as well as the new concept that EMU will give rise to disparate regional booms. We will continue to seek out these companies.

Emerging markets outside Asia have and will continue to be hampered by their higher cost of capital and by investor awareness of the dangers of currency linkages. Where these currency pegs exist without concomitant government restraint and where the domestic financial system has not evolved sufficiently to create a large domestic savings base, these markets can be expected to suffer from low valuations. In this respect, it is not surprising that our investments in Brazil sell on extraordinarily appealing valuations varying from 6-10x 1997 earnings in companies which are both cash generative and virtually debt free.

Our exit from Russia on the grounds of illiquidity looks good in retrospect. We will be evaluating developments there closely but the danger of greed-induced mal-administration has increased recently.

Investment Strategy

The clear risk we are running at present is that the US market breaks to yet higher levels as investors chase "nifty" type stocks which then reach even more exultant valuations à la 1971-73. The sharp inter-market rotation has thrown up value periodically but this could also be a symptom of a rift developing between the value attached to large versus small companies to the detriment of the latter group. The second risk is that Japan becomes more deeply embroiled in the Asian contagion and domestic activity declines. This would clearly suppress profit growth and the improvement in the valuations of the quality stocks.

We plan to add selectively to our list of Japanese holdings to take advantage of recent price collapses. In Europe, we may add to our existing large position (39%) as we pursue the themes noted above. In view of the high valuations in the Western hemisphere, we continue to supplement our cash holdings with an over-hedged position in the US market.

Further, we have bought put options on Japanese Government Bonds (JGBs) on the basis that the support being rendered to the financial system is tantamount to the socialising of debt which inevitably must debase the real value of their currency. With the supply of bonds increasing significantly and the prospect of the yen deteriorating further, this opens up interesting prospects for bonds which yield only 1.9% per annum.

We continue to remain hedged out of the yen and European currencies and into the US dollar. Our current exposure to the Australian dollar is 10%.

Kerr Neilson
Managing Director
7 January 1998