Platinum Capital® Limited Quarterly Investment Manager's Report

31 December 2010

Platinum®
CAPITAL LIMITED

ABN 51 063 975 431

Performance

The markets continued their run that started in August, ignoring the festering issues around the Euro and deleveraging. This shift in the mood coincided with Federal Reserve Chairman Mr Bernanke's pronouncements about quantitative easing, with the market taking the cue as it had following the pattern of earlier Fed bail outs (1994 and 2001). In this instance the Chinese were also adding liquidity on account of unsterilised intervention to hamper the rise of the Chinese Renminbi.

The intervention didn't go entirely to script as the US treasury bonds weakened significantly despite the Fed creating money to exchange for existing government liabilities. The US 10 year government bond rose in yield from 2.4% in early October to 3.5% by year end. Worse still, the TIPS (treasury inflation protected securities/government bonds) suggested that the deterioration in bond prices was being influenced by inflationary concerns as they moved upwards, meaning a higher real cost of borrowing to the Exchequer. At the same time, tight supply conditions and fickle weather led to heightened speculation in the commodity markets with surges in grains, industrial commodities like cotton and rubber, while oil trundled higher to close above $90 a barrel at year end.

Currencies have also been seen as an extension of this bet on strong commodity prices and hence growth. With the shakiness of the Euro and the seemingly imperturbable progress of the developing countries, the currencies of Brazil, Canada and Australia continued to climb. Having looked quite robust in the opening weeks of the quarter, the currencies of Asia quickly lost momentum when it became clear that the Chinese had no intention of allowing the Renminbi to succumb to the full forces of the market.

The developing confidence in the growth outlook found expression in the cyclical components of share markets. Those sectors with defensive qualities lagged by a large margin, even declining in the case of utilities and healthcare – see the following table.

MSCI* World Index Sector Performance (AUD)

SECTOR	QUARTER	1 YEAR
Materials	10%	7%
Energy	9%	-2%
Information Technology	5%	-2%
Industrials	5%	9%
Consumer Discretionary	4%	10%
Financials	0%	-7%
Consumer Staples	-1%	0%
Telecommunications	-2%	-2%
Healthcare	-2%	-10%
Utilities	-4%	-12%

* Morgan Stanley Capital International
Source: MSCI

The surprise to some may be the way the developed markets gained momentum in the last quarter at the expense of the strong economic performers of India, Brazil and China. Time and again, one is reminded that when all are clamouring, the upside potential has often been fully expressed!

For the year as a whole, the MSCI World Index fell by 1.1% when expressed in A$ but was much stronger in their home currencies. The Index rose 2.7% (in A$) for the quarter. By contrast, the performance of Platinum Capital Limited was disappointing; caution being the main culprit. Firstly, this approach led us to avoid the Australian dollar, which we still do as we regard it as a call option on growth, and secondly, the short positions are expensive insurance in a rising market (see sections on 'Currencies' and 'Shorting' for further detail). Importantly, several of our largest holdings (what some would classify as 'blue chips') have reported sound earnings growth yet the market has de-rated them as it chased those with more leverage to the recovery. These holdings are now trading well-below the rating of the market average despite superior track records.

The Company's investment portfolio declined 3.4% (pre-tax) for the year after losing 0.9% for the quarter. Over two years and longer, our performance is well-ahead of the Index but we are conscious that investors look to the short-term for corroboration about the proficiency of their manager.

The following Platinum Capital Limited Net Asset Value figures are after provision for tax on both realised and unrealised income and gains.

Net Asset Value

31 October 2010	$1.2700
30 November 2010	$1.2556
31 December 2010	$1.2517

Source: Platinum

Currencies

We reversed our position on the Asian currencies back into the US dollar when it became apparent that the Chinese were determined to restrain the appreciation of the Renminbi. We also cut exposure to the Euro and ended the quarter with the following exposures:

European currencies 26%, US dollar 24%, Asian currencies ex the Hong Kong dollar 15%, Australian dollar 15%, Hong Kong dollar 12%, Canadian dollar 5% and Japanese yen 3%.

It is not as though we particularly favour the US dollar but in the short-term, evidence of the US economy recovering will provide support. (Incidentally, concerns about fiat money is the principal reason for our holding gold shares).

Shorting

In a market characterised by low dispersion, good and bad rising in tandem, the shorts proved costly. The overall position has remained at around 16% but the composition has shifted. We have introduced shorts on market indices for India and Hong Kong while cutting some of the positions in industrials.

A group of investor sentiment indicators we follow are at extreme levels of optimism. Though recent developments have turned out better than one would have imagined six months ago, it behoves us to run some defensive strategies to cater for disappointment. We would hope to trade around any retracements.

Changes to the Portfolio

Geographical Disposition of Platinum Assets

REGION	DEC 2010	SEP 2010
Asia and Other	30%	31%
Europe	24%	24%
Japan	22%	18%
North America	20%	20%
Cash	4%	7%
Shorts	16%	19%

Source: Platinum

Full valuations after strong rises caused us to remove eBay Inc, Qualcomm and Canon while we reduced holdings in other powerful performers such as Ping An Insurance, BMW, Siemens and Infineon Technology to make way for new names and to top-up laggards. We also trimmed our Chinese exposure on concerns about interest rate tightening, and reduced Johnson & Johnson and Merck because of some temporary product issues and delays in earnings improvements.

The bigger purchases include Shin-Etsu Chemical, Inpex, Shanda Interactive, AMD and some rare metal miners.

Shin-Etsu, described in detail later, highlights the nuances of our analysis.

Inpex might be classified as a cheaply priced call option on energy prices as it creeps closer to exploiting two large resources; the Ichthys wet gas deposit off Australia's North West coast and the Abadi offshore field in Indonesia. It became very cheap after it tackled the market with a rights issue to fund the Ichthys project.

Shanda Interactive is a Nasdaq-listed portal and game publisher operating in China. It has grown strongly and the market is concerned about its ageing gaming portfolio and whether the new portal model it is pioneering will work.

Over half the capitalisation is in cash, implying a low-teen valuation in a fast growing yet still nascent market.

We have owned **AMD** before and believe that with the launch in mid-2011 of new chipsets including an integrated logic/graphic chipset for PCs and laptops, it stands to gain share from Intel.

We have also invested about 1.5% of the Company in a select group of rare metal miners; molybdenum, tungsten, tin and palladium. These are very low tonnage markets, essential in sophisticated industrial processes and with the exception of palladium, are dominated by Chinese producers.

PLATINUM CAPITAL LIMITED – TOP 15 STOCKS

STOCK	INDUSTRY	DEC 10
Samsung Electronics	Semiconductor Equipment	2.3%
Bangkok Bank	Banks	2.2%
Microsoft Corp	Software	2.2%
EcoGreen Fine Chemicals	Chemicals	2.2%
Shin-Etsu Chemical	Chemicals	2.1%
Cisco Systems	Communications Equipment	2.1%
Johnson & Johnson	Health Equipment/Services	2.1%
Henkel AG	Household Products	1.9%
BMW	Autos	1.9%
Siemens AG	Misc. Manufacturing	1.8%
Royal Dutch Shell	Oil and Gas	1.6%
Allianz AG	Insurance	1.6%
Denso Corp	Auto Components	1.6%
Bank of America	Banks	1.6%
Sanofi-Aventis	Pharmaceuticals	1.5%

Source: Platinum

Commentary

It is curious how negatives come to the forefront when there is uncertainty. Over the years, investors' funds have had exposure to so-called 'unattractive' markets like Thailand, Brazil, Peru and India. This was at a time when each was seen as a no-go area and certainly perceived to have no investment merit. Times change as do opportunities – but the immutable fact of investing is that *great investments* are all about buying at the right price.

The no-go zone today is Japan. The market, as a whole, is very cheap by almost all measures though readers will be quick to remind us of the perils of a shrinking population, fiscal disorder, deflation and so forth. However, rather than bore you with macro economic diversions, it is evident that there are many companies that do grow regardless of their home market. A case in point is **Shin-Etsu Chemical** which is based in Japan yet runs a global business. In the 1990s, profits grew by 9% pa compound and this accelerated to 14% pa from 2000 to 2008. (Over this period the Japanese economy has grown by about 1% pa).

At its heart, Shin-Etsu is a chemical company active in the fields of organic and inorganic chemicals, principally polyvinyl chloride (PVC); electronic materials, predominantly semiconductor silicon wafers; and functional materials such as high purity synthetic quartz, rare earth magnets and liquid fluoro-elastomers. Driving growth has been a high commitment to innovation and the broadening of the company's product portfolio. This was accompanied by massive spending on physical plant amounting to ¥1.384 trillion in the last 10 years (approximately US$12.6 billion) yet because of its use of accelerated depreciation and having earned solid profits, the company was able to build-up its cash/investment balances alongside this strong growth. In other words, it was not "buying business" and hence has grown its market share profitably and without the need to resort to outside funding. Even during the global financial crisis, the company continued to make profits, albeit down 55% from the March 2008 peak year. Yes, there are some chemical companies that have done as well but do they trade close to book value with 25% of that lying around as cash?

The most profitable division is that which supplies silicon substrates and materials to the chip making industry. Starting from mining the silica in Australia to the production of silicon metal, to growing defect-free single crystals that are then sawn into 300mm wafers for further enhancement. It is now the dominant global supplier, meeting about one third of worldwide demand of some 3.5 million wafers per month[1] from production bases in Japan, Malaysia, the US, Britain and Taiwan. It has won similar leading positions in the principal materials needed for the subsequent *lithography* process of semi-conductor manufacture (photo-resist films for both krypton and argon fluoride laser exposures, photo-mask blanks and pellicles).

Shin-Etsu is also the **world's largest and lowest cost producer of PVC** – some 3.8 million tonnes pa, two thirds of which are produced in the US. One might conclude that Shin-Etsu is simply a commodity producer – defined as one that has no ability to differentiate its products or processes from those of competitors and consequently must accept a standardised price. This is partly correct but it has carefully chosen its locations and developed products and processes that give it a competitive edge. This is borne out by its return on investment (typically 12 to 15%) and a research and development budget of some US$360 million pa.

In the US for example, gas prices trade well-below the global average and we believe this gives Shin-Etsu a competitive edge of about 20% against the torment of most manufacturers; Chinese competitors – who combined, account for about one third of world capacity.[2] Further, the company has been

1 For all the progress made with line-shrink in semiconductor chip circuits, it may surprise some to find that the demand for wafers in terms of millions of cm^2 has faithfully risen in tandem with growth in physical chip demand. The 20 year growth has been about 8% pa according to Siltronic.

2 The majority of Chinese production (80%) is via coal through a calcium carbide process (limestone + coking coal). Further coal is guzzled to produce Vinyl Chloride Monomer (VCM) using a mercury catalyst. Overall, we estimate 8,000 Kwh of energy is needed to produce one tonne of PVC via this route while producing PVC using ethylene, sourced from natural gas, is far more energy efficient, producing a superior PVC and in terms of materials alone (excluding pollution) costs at least one fifth less. This is equivalent to US$250 per tonne for a product that sells for $1,200-1,400 pt. We see Chinese coal prices likely to continue to rise steeply!

aggressively integrating backwards into VCM which is enhancing its competitiveness.[3]

More recently it has built the leading position in **rare earth magnets** with all their attendant attractions of energy savings in applications such as air conditioner motors and now, the potentially huge market of electric cars. This could be enormous as auto companies seek solutions for thrifty electric motors to drive tomorrow's urban vehicles. A gain in the energy efficiency of the motor translates directly into a car's travelling range. At present, Shin-Etsu's rare earth magnets are running Toyota's Prius hybrid cars. (Hybrid sales accounted for 11% of all car sales in Japan in 2010; Honda expects them to approach the high teens in 2011).

On account of the company directing its research thematically, it continues to show an ability to identify emerging areas of potential growth such as the rare earth super magnets noted above, materials used for encapsulating light emitting diodes (LED's) – silicone moulding materials, lenses and reflectors. It is strong in other silicone products such as liquid elastomers used as a heat cured flexible moulding or sealant in autos, aircraft and electronics.

With all these claimed virtues, **why then is the market pricing the shares so cheaply**; close to half of its historic valuation relative to sales, trend profits and book value? There has been an evident loss of sex appeal for semiconductor wafer manufacturers, supported by oversupply, with 300mm wafer prices down by 45% since 2008.[4] There are also short-term issues such as the strength of the Yen, the weak housing market in America and Europe adversely affecting PVC demand, yet prices are close to their 2008 peak!

We see most of these factors as transient. We have not been able to identify a case where the company's competitive position has actually deteriorated nor is there any evidence that it has been losing its competitive edge to newcomers, substitutes, market decay etc. We believe the exact opposite; seeing it gaining share, and inherent profitability and building know-how in 'emerging giant applications'. Our explanation is that the market is still somewhat uncertain about the short-term end-market demand and is probably too cautious about longer term profit recovery. Foreigners already own close to 40% of the company's issued shares, and as most protest, why buy a Japanese-based investment!

As we have noted repeatedly in the past, there is a predilection for market participants to elute to bright and shiny objects and by so doing, overlook wonderful opportunities that are far superior yet lack immediate appeal. If Shin-Etsu continues to follow its historic pattern of innovation and steady internally-funded growth, we will earn handsome returns. If on the other hand, there is a change in investor perceptions and the excitement rises about the general application of LED lighting, super magnets in electric powered cars, the move to 450mm wafers and improved conditions in housing markets and growing substitution of PVC for aluminium window frames or the like, the shares will provide an investment bonanza.

Shin-Etsu is the Company's fifth largest holding.

Turning back to the general outlook, it was interesting to observe at year end how the markets, other than the A share market in China, brushed off that country's problems with inflation. Some take comfort from the recent retracement of vegetable prices but we suspect the issue is chronic. The country has been growing at breakneck speed for 30 years, capital flows are difficult to control and there is a booming trade in non-bank finance. This is no longer a simple command economy yet the centre, immobilised partially by the impending change of the guard, is trying to use directives to bring back order. The recent hike in the bank rate is way overdue but it looks as though lending controls are going to be the tool of choice. Presumably investors believe slower growth in China and/or a twilight of lower growth and some inflation and Renminbi appreciation is beneficial to other markets and assumes that the spigot of Chinese credit controls will act like a perfect moderator.

Outlook

Evidence of recovery has improved since we last wrote but equally pressures of inflation have become more pronounced in the developing countries. Almost free funding is finding its way into aggressive bets on commodity prices and this is washing into the real economy.

Importantly, we can still find a large number of companies that offer investment merit and we have been adding to these stocks. Our top 15 stocks, as outlined on the previous page, show the diversity in sectors. We are comfortable with these holdings regardless of the environment 2011 may bring. Defensive companies are well-represented and are notably cheap. However, we have also been adding new names which have substantial earnings leverage that should add to the Company's momentum this year.

3 The PVC division has become much deeper as a result of the integration backwards into the production of chlorine (applying electrolysis to salt) and VCM. Output of this intermediary will have doubled by 2011 to 1.6 mt reducing Shin-Etsu's dependence on Dow Chemical – to become about 60% self-sufficient. As a by-product, it will have 530/-t of additional caustic soda to sell. The price of caustic soda in the US has risen from about $100 pt in mid-2009 to over $400 pt now.

4 The 300mm wafer price averaged around ¥15,000 from 2000 to 2006, and peaked at ¥18,000 in 2007/8. Since 2009 it has traded around ¥10,000. Even at this price Shin-Etsu should see a recovery in profits because of the fall in depreciation from ¥100 billion (FY 3/08) to about ¥25 billion this year. We see wafer profits quadrupling from ¥22 billion earned in FY 3/10 by March 2012.

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