The Platinum Japan Fund

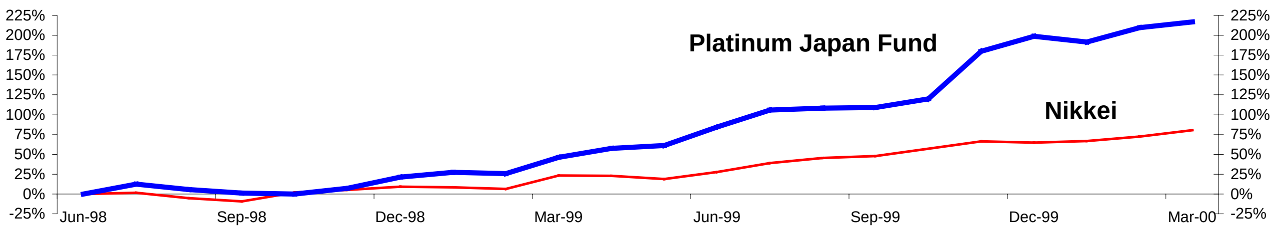
Quarterly Report

31 March 2000

Performance

The Japanese stock market experienced a rather dull quarter with the benchmark Topix index falling by 1%. The hitherto powerful move into the new economy stocks stalled with declines of around 5% in each of the telecom and electronics subsectors of the market. The small cap OTC market was flat. The fund delivered 6.1% return in $A terms against the MSCI Japan index of 8.7%. Stocks that performed well for the fund included the brokers (Nomura, Nikko and Daiwa), Toshiba, Citizen Watch and Nippon Broadcasting. Negative returns were experienced from its Korean holdings where the benchmark Kospi index declined by 16%.

Cumulative Performance Since Inception - 217% (A$)
(1 July 1998 - 31 March 2000)



Commentary

As noted in our previous quarterly we forsee a rising level of merger and acquisition activity in Japan. The March quarter was punctuated by two significant developments in this regard. Firstly there was the takeover of SSP, an over-the-counter drug producer, by Boehringer Ingelheim, a German pharmaceutical manufacturer. Whilst there was an already existing relationship with Boehringer holding 20% of SSP, the tender offer at a 40% premium to the previous close was an unsolicited bid. Although management eventually agreed to the offer it was unusual in the Japanese context to see a foreigner confident enough to act alone. This takeover is also a classic example of the globalisation pressures we think will impact Japan with, in this case, foreign pharmaceutical majors seeking to solidify distribution channels in the world's second largest drug market. The second case involved a hostile takeover bid for an asset holding company called Shoei. This was interesting in that it was initiated by the ex Ministry of Finance people who were involved in drafting the corporate takeover laws. It was financed by a combination of private individuals and corporates (including Orix, one of a small band of non *Keiretsu* mavericks), with the express purpose of unlocking the hidden asset values in Shoei. The bid eventually failed because the major shareholders of Shoei (including Canon) refused to sever the historical corporate ties even though Shoei's demise would have negligible employment implications; having only 42 workers but assets of US$180 million. The bidder having amassed 11% of the company continues to try and improve corporate governance. Whilst this case still highlights the work to be done in breaking down the keiretsu system we remain optimistic that the pressures will build.

We have recently returned from a two week trip through Japan and Korea where we visited 32 companies and a host of industry analysts. Our insights are as follows:

Japan

The economy is showing some modest growth after a period of recession. This is being driven primarily on growing industrial output as global technology spending benefits Japan in the form of greater exports.

Corporate profits are rising, which combined with easy money, is driving the stockmarket. However, overall growth is muted by a weak consumer who still continues to worry either about their jobs or the value of their pensions. We feel that the consumer will continue to lag as companies continue to restructure and perhaps later the government will be a retardant as it moves to pare its massive debt levels. Longer term demographics argue against very high economic growth levels.

Corporate restructuring is continuing, however it has slowed as companies feel comfortable enough with the economic environment not to make further drastic cuts. Some of this is probably also a reflection of the centre where the powers in the LDP have made some obvious moves ahead of the election to slow reform. An example of this was to delay the implementation of a deposit insurance cap for the banks. The sluggishness of reform has as its core the social contract whereby companies are loathe to ask excess employees to leave. Their typical redundancy package runs at about US$150,000 versus annual employee costs of nearly half that amount. A classic example is Nippon Express which is in the fortunate position of having an older work force and hence has seen significant natural employee attrition. Rather than maximising this advantage and down-sizing some of its traditional activities in rail and warehousing, the company has maintained these facilities by hiring contract employees. Hence its allocation of assets continues to be very inefficient and the return on assets is compromised. For corporates as a whole, the outlook is for slower restructuring than we had hoped and corporate profits will rise more slowly.

The internet is likely to be a major influence as Japan is perhaps the country most in need of reform of its bloated wholesale or middleman sector. The typical tied relationships of corporate Japan are likely to come under pressure from improved information dissemination and as face to face contact becomes less important. The internet is only now taking off and has primarily been through mobile phones. This will change as NTT begins to roll out its broadband strategy. From an economic standpoint the downward pressure on prices is likely to persist and this will keep the old economy stocks against the ropes.

Liquidity levels in the financial system will remain very high as a result of this low growth and falling prices so the Bank of Japan, in our view, should be slow to move away from zero rates. Banks are taking excess deposits without a good avenue for lending and the arrival of the postal savings maturities only adds to the problem. There is something like $US1 trillion maturing over the next two years which had previously been earning around 7% and now may earn say 0.5%. Our view is that some of this liquidity will find its way into the equity market. Some should also flow out of the economy in search of higher returns and this could lead to a somewhat weaker yen.

Our conclusion is that our original thesis on Japan still holds. That is, the economy is in the process of a major transformation from the old economic model toward something closer to resembling a modern capitalist economy. This will create winners and losers as industries rise and fall. During this process economic growth will be sluggish as resources are redistributed around the economy and this makes selection of stocks in the right areas all the more important. We would prefer to buy those companies with an existing high return on capital, that are generating free cashflow and have the avenue of some growth rather than to delve into the really difficult industries in the hope of some broad economic recovery lifting all boats. We would also still be attracted to the fine old deep technology companies of Japan such as MEI, Fujitsu or Toshiba. We are particularly interested in areas where the Japanese seem likely to become stronger such as mobile, digital broadcasting, home networks and new chip technologies.

Korea

In Korea, we see the situation as very different to Japan. Whilst they share a lot of similar characteristics in terms of industries and the economic structures, they appear better placed because:

- Real change was crystallised by the advent of what the locals refer to as “the IMF crisis” which brought change in both political leadership and the banking system (the latter having essentially disintegrated). Neither of these happened in Japan. The upshot was that the *chaebol* system was irrevocably undermined and has resulted in the removal of all cross guarantees between group companies, the breakup of the Hyundai group into four components and the extinction of Daewoo.

- Unemployment rose to 9% at its peak as major corporates were able to retrench people and although it has since snapped back to 5% a lot of this is via part-time contracts. The social contract appears to have been replaced by a more market orientated approach than in Japan simply because the need for change was greater.

- There is natural growth in the economy as the population is much younger than in Japan and because its GDP per head is less than one third of Japans.

The most startling thing about Korea is the extent of its adoption of the “new technologies”. This desire to be at the forefront of new technologies is coming from the very top with the president expousing the virtues of business to business (B2B) commerce in transforming the economy. As a country they are amongst the world's leading adopters of mobile technology (the first country to commercialise CDMA) and broadband internet, with approximately 15 million internet users or 33% of the population. One can forget about Playstation in Korea, the country already has the world's leading on-line gaming community. The game "Starcraft" is a social phenomena and is played at the more than 10,000 PC *Bangs* (or downmarket internet cafes) that line Korean streets. Stockbrokers are cutting each other throats with extraordinarily cheap execution fees to make Korea the leading user of on-line trading. Sixty percent of stock market trades are now transacted over the internet.

This "technology drive" is encouraging a venture capital boom similar to that in Silicon Valley. While the technology level is still well behind the big nations, they are progressing from being mere implementors toward adding value to both hardware and software. Among the examples we came across were:

Handysoft – a seller of workflow solutions software to the US Dept of Defence.
Uniwide – developed server storage solutions in full fibre channel capable of 200mb/sec data transfer rates.
Opicom – video streaming compression technology for digital broadcasting.

About 50% of the companies we saw were from this "new economy" area and they exuded a completely different feel to those companies we met with a *chaebol* heritage. Here you have companies addressing new growth markets, where employees generally have ownership via stock options and where the people staffing the R&D labs have generally defected from a major *chaebol*. In many cases government sponsored initiatives, in the field of telecom research or software incubation, have been placed in the private sector once the intellectual property has commercial viability.

Whilst there is an obvious risk that this is all just a bubble and that funds will be wasted on misinvestment and speculation, the benefits in terms of rising labour mobility, improving domestic technical capabilities and the mobilisation of capital from sources other than the banks, will be long lasting.

We are very conscious of earlier episodes of excess but at least today there is less economic concentration and much lower corporate gearing. The country's finances are in good shape and its export prospects as good as ever. As this feeds back into the domestic economy, the prospect for growth of twice that of the developed world is highly probable.

Changes to the Portfolio

We have cutback exposure to the telecom's by removing all of our holding in Korea Telecom (4% holding) at prices of 123,000 versus an entry cost of 45,000. We have also halved our position in SK Telecom because of price appreciation but would be buyers on any major pullback as the company continues to get stronger. In Japan we removed our position in Mitsubishi Heavy in favour of Sekisui Chemical.

In terms of currency we have reduced the yen exposure to 29% and introduced some Euro and $A as we believe the Japanese economy is not strong enough to sustain a much stronger yen and that Europe is better placed in this regard.

Breakdown of Portfolio

Categories	Examples of Stocks	Mar 2000	Dec 1999
Cyclical Growth	Sony, Kyocera, Matsushita Electric	20%	22%
High Growth	Mobile Telecoms - DDI, DoCoMo Broadcasters – Tokyo and Nippon Broadcasting	17%	18%
Market Sensitive	Daiwa, Nikko and Nomura Securities	11%	9%
Deep Value Cyclicals	National House, Taikisha, Sekisui Chemical	11%	9%
Steady Growth	Coca Cola Bottlers, Drug Wholesalers	7%	7%
Korea	SK Telecom, Lottecon, Medison	21%	24%
Cash		13%	11%

The Fund size is currently $85 million.

12 April 2000