The Platinum Japan Fund

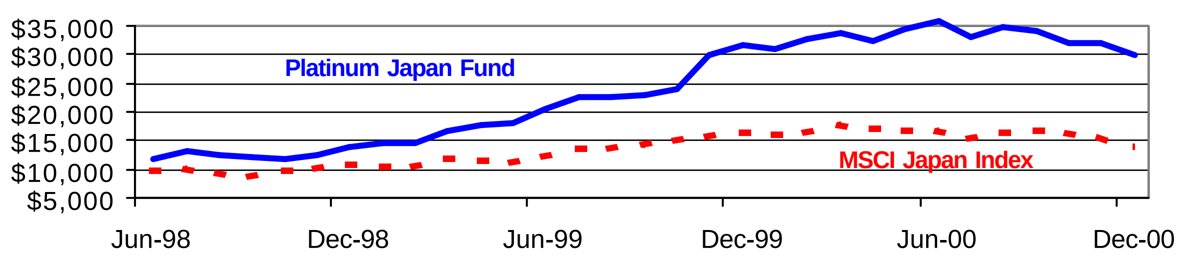
Quarterly Report

31 December 2000

Redemption Price: $1.8030   Fund Size: $75 Million

Performance

CUMULATIVE PERFORMANCE SINCE INCEPTION (1 JULY 1998 – 31 DECEMBER 2000)



The quarter saw the continuation of extremely difficult conditions for the Japanese equity market with the benchmark Topix index declining by 12.7%. The standout decline was in the communications sector which fell by 32% as it started to digest the large increase in stock supply from the NTT group. Technology areas were also weak with many sectors registering declines in the order of 20%. On the positive side there was movement towards defensive areas and this benefited domestic names in the airline, insurance and electric utility indices which all rose. The Fund was not able to withstand the downdraft in markets and declined by 13.1% over the quarter versus the MSCI Japan index which fell by 17.4% both in A$ terms. The performance of the Fund was significantly helped by the rise in the Euro against the yen, a position which had detracted from performance in previous periods. Over the quarter the Euro rose by 12.8% against the yen and at quarter end the Fund was hedged for about 41% of its value into Euro's.

The last twelve months have seen miserable performances from the markets in which your Fund has been invested. The benchmark Topix index of Japanese shares fell 25.5% for the year whilst in Korea, the Kospi index fell by 50.9%! The decline was much greater amongst the smaller indices oriented toward new technology companies with the Japanese OTC market down by 45.3% and the Kosdaq market in Korea down by 79.5%! Against this backdrop the Fund declined by a modest 6% for the year versus a decline of 15.4% in the MSCI Japan index in A$ terms. The compound return per annum over the past two years for the Fund has been 52.2% versus 13.2% for the MSCI Japan.

Commentary

We have recently returned from a trip to Japan where we visited over thirty companies. The bulk of our visits were concentrated in the technology area where the major themes we pursued were optical communications, W-CDMA mobile communications, digital photography and network integration. Our conclusions about the economic prospects for Japan remain essentially unchanged from those previously outlined. The pace of restructuring is clearly too slow and consequently economic growth will remain subdued until this changes.

It is highly apparent that Japan is an extremely disparate economy. Our visits to technology companies continually reinforce our belief that Japan has enormous depth in this field. These companies are highly attuned to the nature of global competition and have never backed off from their commitment to R&D. In the digital age, which we define as essentially network driven, where all electronics appliances are capable of interaction at high speeds, the Japanese are at the forefront. We would sight consumer electronics, mobile communications, components and high precision machine tools as being highly prospective areas for Japanese companies. In stark contrast, our visits to companies linked to the very core of the traditional economic model, such as financial companies and even companies like Hitachi, which are vast in the scale of their operations, make one realise that they have probably only just begun to think about change, let alone to address their problems.

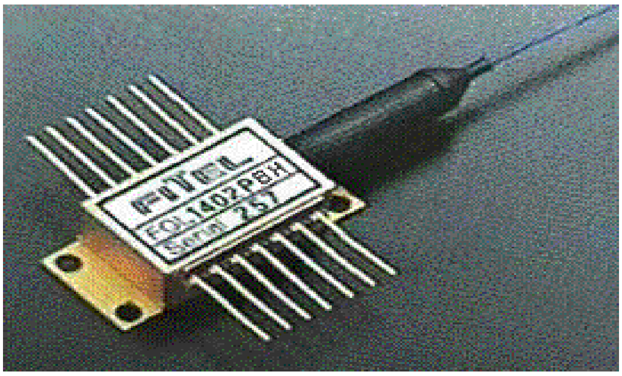
These traditional companies are perhaps best represented by Tokio Marine & Fire (TM&F). The company is the leader in general insurance products and has a very strong financial position. The insurance industry in Japan has typically been highly regulated with premiums, types of policies and payments to agents all being set by the government. However the industry has been deregulated over the past three years and there are new entrants trying to take market share. The problem for TM&F is that the new entrants (largely foreigners such as AIG) have expense ratios of perhaps 20% of revenues whereas TM&F has a much higher expense ratio at around 36% of revenues. The normal response would be to cut costs aggressively including directly selling to clients in order to reduce agents fees. However, this is complicated by an almost total reliance on tied agents which the company openly admits would be hard to reduce. They have typically had a long term relationship with these agents and they dare not risk losing the business by selling directly to customers. We believe this is a highly reactionary view to doing business. Wouldn’t it be better to ask what profits they make from this relationship rather than assume that what was good in the past is good for the future? Of course, the company will change the way it operates but if it is only in response to a weakening market position, that is hardly reassuring? Certainly the stock is cheap against its book value but what is book value worth when they could quite easily fritter it away on rising underwriting losses and poor equity investments.

The story of TM&F is a microcosm of what is going on in Japan today. Our view is that the entire country is living quite comfortably off the high living standards created by the hard labours of the post-war generation. People don’t feel particularly optimistic but by the same token they feel quite comfortable in the sanctity of the economic system which coddles their existence. Unemployment is not a pressing issue and the strong currency preserves the illusion of strength. We feel this process will continue until living standards have been eroded toward those prevailing in western nations which will mean either 10 more years of little economic growth or perhaps a currency at 160 to the US dollar.

We cannot emphasise enough the generational aspect. Senior managers, both corporate and government, feel that they deserve to enjoy their time at the top after slaving through the seniority system and feel little compunction to radically alter the status quo. Until the current generation of leaders starts to move on, real change will probably remain elusive. Perhaps it is correct to focus on the fortunes of the LDP as the beacon of change in this respect.

This is not to say that all is stagnant in Japan. The positives we can detect include a much more open attitude from companies which are now at least willing to discuss issues whereas before they would purely deliver their version of events. There is also a heightened awareness of what has gone on in the US, particularly with the way Nasdaq has mobilised risk capital and allowed ideas to be transformed into businesses. As a general rule, we found that the further we moved away from Tokyo, the more communicative and progressive the companies became. In Kyoto we even encountered a company that would have given any Silicon Valley tech outfit a run for its money in terms of stock promotion. We feel in general that such awareness will have long term positive implications for shareholder returns.

We devoted a substantial part of our time to seeing companies in the optical communications area - nine companies in total. In this arena the first companies that come to mind are the US-based market darlings such as Nortel, Corning and JDS Uniphase. However, what often doesn’t get any airplay is that Japanese component manufacturers are very significant suppliers to these companies. The history behind this is one of those typical stories which highlights the technical depth of Japan. From the mid-70s when optical fibre was first introduced to Japan, NTT and its affiliate suppliers set about long term planning of how to benefit from this technology including the components that serve to boost transmission speeds. Whilst NTT subsequently chose to adopt higher speed optic fibre than its Western competitors, it slowed the adoption of WDM (wave division multiplexing – sending multiple signals down a single optical fibre). The boom in US spending on WDM has left the Japanese suppliers well placed to capitalise.



This matcbox size device – pump laser sells for approx. US$1,500.

Perhaps the best example of this is the Japanese WDM market leader, Furukawa Electric. In the early nineties when NTT slowed its spending on optical fibre, Furukawa branched its R&D into optical components. At the same time they invested in a start-up "garage company" called JDS, which at the time was a four person company with some bright ideas about optical networks and passive optical components. To help JDS out, they gave them distribution rights to Furukawa products sold in the US. The rest of the story is well documented with JDS growing alongside the flowering technology of WDM into the market leader it is today. Along the way it merged with Uniphase (giving it a broader product line which included actives) and more lately with E-Tek and SDL. Furukawa's roll in the company has gradually waned to that of a pure shareholder with a current stake of 14%. However, what is less well documented is that during the time that JDS was emerging, Furukawa was also working on some interesting technologies of its own, many of which now compete with or are supplied to JDSU. Its major product is the 1480nm pump laser for which it dominates the world market. These are the power sources used in amplifiers that serve to boost the optical signals as they progress down the optic fibre trunk lines and are absolutely essential to the system. Their position seems to be even stronger in next generation Raman amplifier technology which uses even more powerful pump lasers. In addition they are working to broaden their product range in components with passives (fibre bragg grating, couplers), source lasers and amplifier modules.

While the US optical stocks appear expensive, the Japanese stocks are in many cases still attractive. In addition, it is likely that when NTT lowers its tariffs for broadband access they will need to spend on WDM to facilitate the extra data volumes this will create. This will directly benefit the Japanese component companies and the systems companies such as NEC and Fujitsu.

Looking at the valuation of Furukawa we see that at a current price of 2000 yen it is trading on 50x current year operating earnings. However its 14% holding of JDSU is worth 1080 yen and if we adjust for this, the stock could be seen to be on 23x. Although we do not own the stock, this valuation is interesting when you also consider that the company is restructuring heavily away from its old industry areas into optical components and profits should continue to rise strongly as a result.

Other companies we saw in the optical communications space that appeared interesting were:

Sumitomo Electric – although a larger company in terms of total sales, this company is a close second to Furukawa in optical components. Its major products are optical datalinks (world's largest), semiconductor source lasers (second to Lucent) and pump lasers (second to Furukawa). It is also well placed in the basic materials that act as the substrates for advanced semiconductors including those used in pump lasers. The stock is on 38x the current year's earnings forecast.

Anritsu – this company presently dominates the global market for 10gbps optical testing equipment but also has products in mobile communications testing and testing for optical components. (The visit to Sumitomo Electric highlighted that the major bottleneck for production is testing equipment). The company is also a smaller player in the optical components area including pump lasers.

FDK – an affiliate of Fujitsu, this company uses its core technology in crystal devices to secure a 40% world market share for optical isolators with JDSU as its major rival. The company is more of a general components company with interesting technology in VCO (supplied to Nokia), ferrites for power sources and has a joint venture in batteries with Sony. It is now paying closer attention to profitability having recently exited the magnetic head business.

Moritex – its core business is optical fibre illumination systems used in high precision machine tools. However, the interesting product the company has is its automated alignment system for optical fibre strands and laser diodes/arrayed waveguides at very high levels of precision. There seem to be only three companies in the world producing these machines. Their importance lies in the fact that without these machines, the laborious assembly process is done by hand. If the optic fibres and the device are not correctly aligned there can be major loss of signal strength. For next generation optical switch products the company is talking about being able to align 32 fibres from each of four directions onto a control chip.

Outlook

The Japanese market fell substantially in 2000 giving back a large part of the gains achieved in 1999. The fall is much worse for sentiment when you consider that we seemed to be embracing the "new economy" and all of the benefits this would have for the structure of the economy but in reality we have had a liquidity driven bubble that has left large losses amongst the investing public. The likes of Softbank that were so anointed as an agent of change have been roundly trounced and arguably this prolongs (or terminates) the economic transformation. However we feel that this has probably been reflected in the equity market and that a different version of the new economy will emerge, this time probably amongst the likes of NEC and Toshiba. These are technology companies with a "foot" in the old Japan but the momentum to actually breakout on the upside. In terms of the index it is now pretty much in the middle of its five year trading range which means if you have any belief at all you should be a buyer not a seller. The worst case would probably be a US recession in which case the market could test its old lows but would then probably be back at current levels quite quickly. In this environment we will continue to accumulate the stocks we like with a major bias toward technology stocks. These companies can grow without the help of the economy.

Changes to the Portfolio

During the quarter we consolidated the portfolio by removing a number of stocks in favour of larger positions in our core holdings. We sold our positions in the shipping stocks, Mitsui OSK and NYK. Although we only recently purchased these holdings the decline in prices in the technology area made those investments more compelling. We also sold our positions in Citizen Watch, Namco, Minebea and Citizen Electronics and reduced exposure to Anritsu which had appreciated 300% from our entry point. With the proceeds of these sales we increased our positions in Fujitsu, NTT, DDI and Toshiba which on average had fallen 23% over the quarter. We also chose to substantially increase our exposure to Korea as that market has probably seen the worst after it declined by 50% in 2000. We initiated a new position in Samsung Electronics whilst substantially raising our positions in LG Advertising and LG Chemical. We also added a 4% long position in Kospi futures which raised our effective exposure. On the short side we reduced our total position from 17% to 5% of the portfolio as the prices of these stocks declined. Our currency positions were largely unchanged during the quarter, with the Yen/Euro position looking very promising.

BREAKDOWN BY INDUSTRY

Categories	Examples of Stocks	Dec 2000	Sep 2000
Cyclical Growth	Anritsu, Toshiba	26%	32%
High Growth	DDI Corp, NTT, Japanese Broadcasters	14%	18%
Deep Value Cyclicals	Taikisha, Noritake	15%	17%
Steady Growth	Nintendo, Kinki Coca Cola	8%	7%
Market Sensitive	Nikko and Nomura Securities	6%	6%
Korea	SK Telecom, Samsung Electronics, Medison	17%	14%
Cash		14%	6%

INVESTED POSITION

Region	Dec 2000	Sep 2000
Japan	69%	81%
Korea	17%	14%
Cash	13%	5%

The Fund's short position is 0.7% against the Kospi (Korean index) and 4.6% against individual Japanese companies.