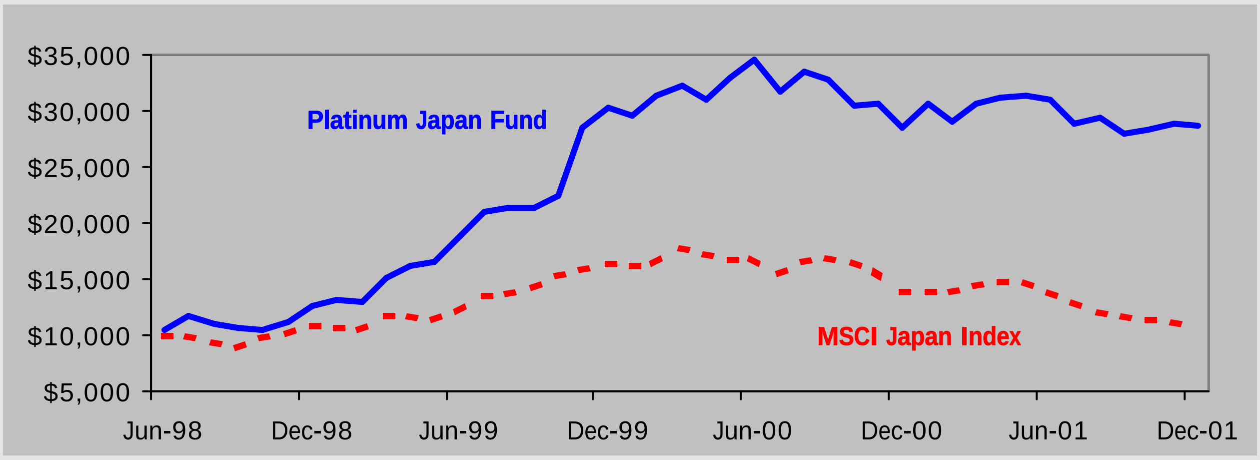
The Platinum Japan Fund

REDEMPTION PRICE: $1.7443

Performance

VALUE OF $10,000 INVESTED SINCE INCEPTION (1 JULY 1998 – 31 DECEMBER 2001)



The Japanese stockmarket performed sluggishly over the quarter, failing to show any rebound from the substantial declines of the preceding quarter. The benchmark MSCI Japan Index was up 3.5% in yen terms, but declined by 6% in US$ terms, as the yen depreciated sharply. There was clear divergence within the market, as the technology-based electrical machinery index rose 23% on the back of similar gains in the Nasdaq, while domestic focused stocks struggled, with the banking index leading the declines with a 20% fall. The concern of investors for the health of the Japanese financial system was evident, especially when contrasted with US and European markets, where the indices both rose 10% in US$ terms. The surprise performer was the Korean equity market which rose 56% in US$ terms over the quarter and was clearly the best performer among major equity markets. Foreign investors bought Korean stocks aggressively as they anticipated a better global economic environment and recognised the benefits of strong domestic consumption.

Our Fund managed to perform well during the period rising by 2.9% in A$ terms, whilst the MSCI Japan Index fell 9.3% in A$ terms. This was primarily attributable to the good performance of our Korean positions and in a relative sense, our hedge out of yen into both the A$ and the Euro. The biggest contributors to our gains were Korean: LG Advertising which rose 88%, Lotte Confectionery, gaining 58%, and LG Chemical, which rose 55%. On the downside, there was NTT's fall of 23%, while our positions in the banks, which we sold out of during the quarter, hurt performance. Over the 2001 calendar year, the performance of the Fund was 0.6% versus that of the MSCI Japan Index –23.4% in A$.

Changes to the Portfolio

Our main action was to trim the positions where we have become overly exposed on account of strong price rises. As noted above, our big winner was LG Advertising, which rose on the back of negotiations with international advertising giant WPP, which is seeking to take a controlling stake in LG. This announcement caused the valuation discount that had existed on the stock to evaporate. However, it is still not expensive. Generally, we continue to find real value in our holdings in Korea, despite rapid price appreciations.

In terms of the Fund's Japanese stocks, the major changes were the removal of our positions in the bank stocks, and the trimming back of our exposure to property companies. We once again misjudged the Bank of Japan (BOJ), believing that Japan's central bank would aggressively act against the rising deflationary forces at home through an aggressive easing of policy, especially with a legitimate excuse provided by the September 11 terrorist attacks. The consequence of the BOJ's failure to respond has been to place further pressure on the domestic economy resulting in more bankruptcies and adding to the nervousness of the stockmarket. We still think the BOJ will be forced to move towards more aggressive monetary easing which should boost finance and property-related stocks, but the timing of such action seems to have been extended again.

A new addition to the portfolio this quarter is Japan's Alpine Electronics. Many readers would be familiar with the company for its car audio products which account for 62% of sales. This is a mature and highly competitive business, although the company is clearly in the top tier of producers in terms of its market share, profit margins, brand quality and a blue-chip client list which is headed by Honda, BMW and Mercedes. Surprisingly, the company has managed to grow its sales at 7%pa over the past ten years which testifies to its strength. The exciting part of the Alpine story is its burgeoning car navigation business which currently accounts for 25% of sales and which grew 44% last year! Our feeling is that car navigation systems will become a standard, mass-market product, similar in its ubiquity to the mobile phone. Starting first with luxury cars, it will gradually become a common device in hire cars and medium priced automobiles. The desire for consumers to have access to services in their cars, like electronic street directories with voice-activation, electronic toll collection, in-car TV and video entertainment as well as internet access, should prove compelling. The implications for Alpine are a much larger target market for its products, but also a greater level of complexity in terms of customer expectations and the technology involved in meeting these needs. The technological complexity comes from the need to integrate communications technology (GPS, mobile information downloads etc) with new components, and the software necessary to drive the electronic maps, internet access etc. Fortunately Alpine is very well placed, as it has been working toward this new business model for some time. This is evident from the increase in its R&D-to-sales ratio, which has risen from 3% to 7% over the past decade. The company also draws strength from its partnerships with the likes of BMW in the development of total systems; its parent, Alps Electric with regard to components and Nokia for communications technology. At present, only 8% of new cars are shipped with car navigation as a standard inclusion but projections have that figure rising to 30% within ten years.

DISPOSITION OF ASSETS

Region	Dec 2001	Sep 2001
Japan	64%	68%
Korea	24%	21%
Cash	12%	11%
Shorts	16%	11%

We think the company is attractively priced at 20 times earnings. It is a major beneficiary of a weaker yen, with 71% of sales overseas, so the domestic problems of Japan are not really relevant to Alpine. Sales should continue to grow at 7% and profits could grow at 15% pa for some time, with margins rising from very low levels, as some of the forward investment in R&D is recovered.

On the thematic level, we are adding to the Fund's holdings of companies that will benefit from the soccer World Cup to be held in Japan and Korea over May/June 2002. The broadcasting and advertising companies are therefore of interest, but in addition, these businesses show very solid long-term records of growth and profitability, while being valued near historical lows. Even through the post-bubble recessions these companies have grown earnings nearly every year.

Our short positions are now entirely against individual Japanese stocks, primarily in the technology area. We have increased our short interests to 16% of the Fund. We closed our 5% short position against the Korean market during the quarter prior to the major upward move in the market.

The currency position is largely unchanged at 55% in A$, 26% in Euro and 19% in yen.

BREAKDOWN BY INDUSTRY

Categories	Examples of Stocks	Dec 2001	Sep 2001
Restructuring	NTT, MEI, Toshiba, Takeda Chemical	18%	16%
Thematic	Noritake, Mizuho, TOC Corp	13%	22%
Hidden Assets	Nippon Broadcasting, Toyo Tec, Taikisha	9%	9%
Growth Stocks	Furukawa Electric, Aiful Corporation	8%	9%
Cash Generators	Air Liquide Japan, Enix Corporation	8%	6%
Other	Alpine Electronics	6%	5%
Korea	LG Chemical, Korea Telecom, Samsung Electronics	24%	22%
Cash/Margin Deposits		14%	11%

Commentary

The quarter saw a sharp divergence between the performance of most world markets and that of Japan. While the trend globally was to lift share prices in anticipation of the expected economic recovery, Japanese shares failed to respond. Clearly the interpretation by investors was that the countries structural problems greatly outweigh the benefits from a turn in the global cycle. With the Japanese having just entered their third recession of the last ten years, the market is less willing to overlook these domestic structural problems than it may have done in the past.

What is the core of the problem?

Simply put, Japan has never fully dealt with the problems which arose from the so-called economic bubble of the 1980s which had delivered staggering rises in incomes and wealth levels. As with any 'bubble', there are some foundations to the initial stages of development – in this case it was Japan's clear leadership in technological innovation – but this factor of success was allowed to feed into an asset-price bubble through loose monetary policy. During the last ten years, we have clearly seen a 'de-bubbling' of asset prices. However, we have not witnessed a real economic contraction as yet. The real economy has been cushioned by massive government spending on an unprecedented scale, with total debt as a proportion of GDP approaching 700%. However, the spending is only supportable in the long-term so long as the assets being kept afloat generate a reasonable return. With interest rates stuck at 0% and the economy in recession, this will not happen. Meanwhile, the technological lead that Japan once enjoyed has now narrowed considerably. This has to impinge negatively on living standards. In this regard, the recent downgrades of Japanese government debt by the ratings agencies, albeit late, are probably the best sign that the game is up.

Where does it end?

Clearly, there is a variety of possible scenarios ranging from the benign to the diabolical. One view might be that Japanese GDP per head should be no greater than that typical of most European countries since Japan possesses no significant competitive advantage. By this measure, GDP per head in US$ could fall by 30%. This adjustment could be achieved either by substantial currency depreciation or by a more benign mix of currency depreciation and nominal GDP falling as prices deflate, as we have had for some time.

The former is likely to have damaging flow-on effects to competing countries such as Korea, Taiwan and to an extent Euroland which competes heavily in the area of capital goods. However, intuitively, if the market thinks the time is up, the Japanese may not have the luxury of choosing such a "gentle option" as presented in scenario two.

On another level altogether, it is hard to believe that the recognition of the failure of Japan's post-war economic model will not start a chain reaction of political and social change. We have not seen this yet.

Are there any positive indications that the worst-case scenario might be avoided?

We can see some encouraging signs. There are companies which are dismissing staff. Unemployment has reached 5.6% and appears set to go considerably higher. We would look for a 10% unemployment rate to possibly signal the end of

Japan's immediate dilemma. Also, some larger-sized bankruptcies have occurred recently such as those of Mycal and Aoki, which are surely indicative of a declining desire to prop up weaker companies when they are on the brink. However, despite depressed sentiment, there is no panic in the streets and the basic institutions of government are sound. We expect this calm to be tested before the turn.

What about the equity market?

It is difficult to regard the current environment for Japanese equities as good. Perhaps the best outcome for the market would be a very sharp drop in the value of the yen, in order to clear the blockages in the economy and cause a move to a new economic model. More generally, in this environment, companies with considerable offshore businesses or those companies with Japanese businesses, which would benefit from the removal of weaker competitors, are the ideal portfolio candidates.

Generally, the level of correlation between the Japanese and Korean markets is quite high because of the number of industries in which the two economies compete. However, investors now seem to be ascribing very "Japan-specific" problems to that market while embracing the Korean story. We have often commented on the relative attractions of Korea versus Japan and it appears that the market is now sharing this view. The most important factor at present is the vibrancy of the Korean domestic economy, a point for which Korea is not often famed. This can be attributed to two major factors. Firstly, the cheapness of the Korean currency since the Asian crisis has enabled export businesses to continue taking share from the Japanese and kept unemployment levels in the 3-5% range. Secondly, this positive employment situation and greater labour flexibility has translated into an outlook of confidence, reflected in surging consumer spending. The government has further accommodated this trend by opening up previously closed channels for consumer lending such as credit cards. With the dramatic fall in interest rates from typically around 10% to the 4-5% range, the consumer has not only run down his savings but has begun to borrow. While this may cause alarm, the Korean consumer has historically been very 'under-borrowed' and as such has plenty of capacity. These same arguments could theoretically apply to Japan, but that economy has an older population that is fearful of job security and hence internal growth may be more elusive. Looking ahead, the major challenge for Korea is likely to come from substantial yen depreciation as Japan tries to reflate. However, Korea is more capable than ever of handling such a scenario with over US$100 billion in foreign exchange reserves and it can also let the Won depreciate. All the same, such a situation would cause many to review investing in Korea. In the end, investors would likely view such conditions as a major buying opportunity. We remain very interested in the Korean market, as we believe that we can still find many strong companies at ludicrously cheap valuations.

Outlook

We continue to expect difficult conditions for equity markets, as the US stock market remains expensive for the levels of economic growth likely to be achieved in that economy during the next few years. Japan seems less likely to be helped by global circumstances, and this may generate further market pressure and policy responses. Generally, we are encouraged by the value we can see in individual stock names, but the trick will be to discern the degree of vulnerability of such companies to the patchy economic conditions that we anticipate. It is likely to be a fruitful period for stock pickers.

Jim Simpson
Portfolio Manager