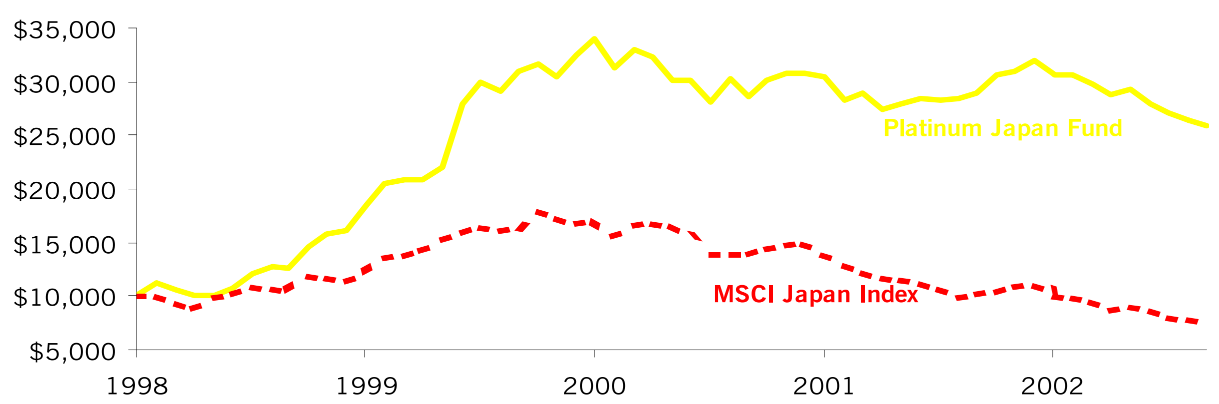
Platinum Japan Fund

Performance

REDEMPTION PRICE: $1.4709

VALUE OF $10,000 INVESTED SINCE INCEPTION (1 JULY 1998 – 31 MARCH 2003)



Source: Platinum and MSCI

The Japanese market continued its decline this quarter with the benchmark Topix index down 6.6% in local currency terms. Investors were disappointed that the choice of the new Bank of Japan (BOJ) Governor Fukui seemed likely to lead to the current monetary policy settings being maintained. In addition, very large preferred share issues by the banks in an attempt to stave off nationalisation weighed down the finance sector. Declines in financial stocks were balanced somewhat by broad gains in the industrial sectors of the market such as shipping and steel which are perceived beneficiaries of Chinese growth. In Korea, the market was considerably weaker, declining by 14.6% in local currency terms with the Won weakening by 5.8% against an already weak US$. Apart from the obvious concerns surrounding North Korea there were numerous domestic factors which drove the market down (see commentary).

The Fund was down by 7.4% over the quarter in A$ terms as compared with a decline of 14.1% in the MSCI Japan index. The main differentiating factor was the hedge into A$ (now at 72% of the Fund) which benefited as the A$ rose by 6.7% against the yen during the period. In terms of stocks, strong performers were Citizen Watch (strong LED sales for use in handsets), Komatsu and Canon Sales. On the negative side our Korean stocks including Korea Telecom and Lotte Confectionary had sizeable falls as did Aiful and Ushio in Japan. For the year to 31 March 2003, the Fund fell by 15.5% in A$ terms but substantially outperformed the MSCI Japan index which declined by 28.1%.

Changes to the Portfolio

We added new positions in NTT Docomo, Yamato Transport, Daiwa House and Mitsubishi Corporation. These purchases were financed by sales of holdings in Fujirebio, Sky Perfect, Sohgo Security, Sony and Kookmin Bank as well as partial sales of NTT and Matsushita Electric.

The Fund sold its entire long position in Nikkei Index futures as it appeared the market would break to lower ground as relative values elsewhere, especially in Europe, adjusted sharply lower over the quarter. This proved to be the case.

DISPOSITION OF ASSETS

Region	Mar 2003	Dec 2002
Japan	72%	75%
Korea	11%	16%
Cash	17%	9%
Short Derivatives	-6%	-9%
Long Derivatives	7%	11%
Net Derivatives	1%	3%
Net Invested	84%	94%

Source: Platinum

Currency exposures were further weighted toward the A$ with 10% of the Korean Won exposure being hedged into A$ before the sharp deterioration of the Won. We continue to believe that the A$ is a relatively attractive currency due to Australia's weighting to commodities and the Asian region in general.

Commentary

As we commented in our last report, there was an opportunity for the Japanese government to embrace a more activist stance in the economy by appointing an aggressive BOJ governor. As it transpired this was not the case and the leading consensus candidate Mr Fukui was appointed. So far it appears his policies will be an incremental continuation of those of his predecessor Mr Hayami and in that sense it is a disappointment. For his part, Prime Minister Koizumi now seems increasingly incapable of bold action and appears isolated even within his own party. This may mean that he suffers a serious challenge to his leadership at the next LDP leadership election due later this year. This is not positive news for the market in the short run.

The most interesting development in Korea this quarter was uncovering by government investigators of fraudulent accounting at the SK Chaebol company, SK Global. This fraud involved the company systematically overstating profits and understating debt (around US$1 billion) in an attempt to hide its weak financial position subsequent to the purchase of SK Telecom shares off the government many years ago. The impact of this revelation on financial market psychology was very direct:

- It served as a reminder of the bad old days of the Asian crisis and such corporate failures as Daewoo where fraud was widespread.
- Bond fund investors withdrew money on fears that the insolvency of the SK group would lead to defaults. This effectively froze the bond market for a period, triggering problems for the credit card companies who were trying to refinance.
- A fear of whom is next amongst the big chaebols?

The SK scandal serves as a stark reminder of the risks inherent in all equity markets, not just in Korea, with similar (fraudulent) activities being reported in the US in recent times. In regards to Korea we would continue to avoid the highly indebted mid-sized chaebol companies, of which SK was one, for fear that similar practices may have occurred. The reality is that high levels of debt give a group little room for movement when hit by shocks. The same negative view applies to the banks which despite some positive reforms are still party to many of the bad aspects of the Korean system.

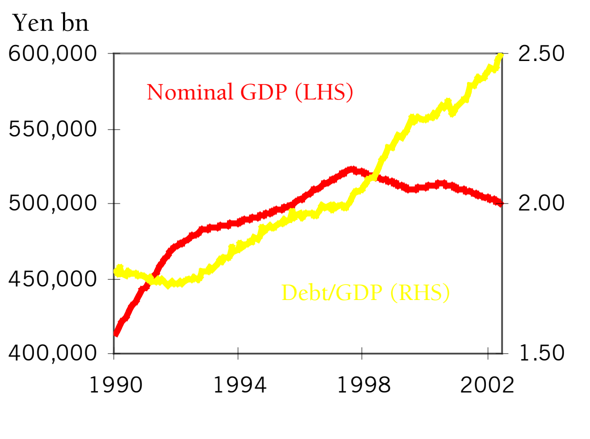
On the positive side these events are generally helpful in improving investor confidence over the medium term. We note that from the Korean perspective and especially relative to history, the authorities have moved especially swiftly in this case. The top 20 executives from the SK group face charges and the major shareholder has had to relinquish his shares in group companies. The banks have moved very quickly towards an orderly workout. We would also point out that from a macro perspective Korea has reduced debt significantly in recent years and these events are really hangovers from a murky past. For reference, the Daewoo fraud ended with total debts of around $80 billion of which probably $5-10 billion was recovered. SK group has every chance of being able to meet all of its commitments.

Debt and the Japanese Economy

Recently we reviewed the Japanese Banking sector and the level and composition of total debt in the wider economy. What immediately stood out from a macroeconomic perspective is that the fundamentals of the Japanese economy continue to steadily deteriorate. Japan's Debt/GDP ratio (a kind of debt service ratio) continues to rise sharply with both rising debt levels and falling nominal GDP (see chart). The ratio itself remains at a level well above those of the western economies and indicates that despite 10 years of recession the economy remains dangerously leveraged. This is clearly an unsustainable situation and the financial markets are at some stage, perhaps in the relatively near future, likely to force a resolution. This is likely to be some form of rejection by the financial markets of the endless accumulation of government debt (see chart). This could be triggered by credit rating agency downgrades or in an extreme scenario, bank runs. Should this happen, the government would then have to make a choice between further retrenchment in the economy (as debt was reduced) or the more palatable solution of inflation (raising nominal GDP) through a weakening currency and a relative reduction in standard of living for Japanese. Under this second scenario we see short positions on the yen and JGB's and long positions in select exporting stocks as the best positioning.

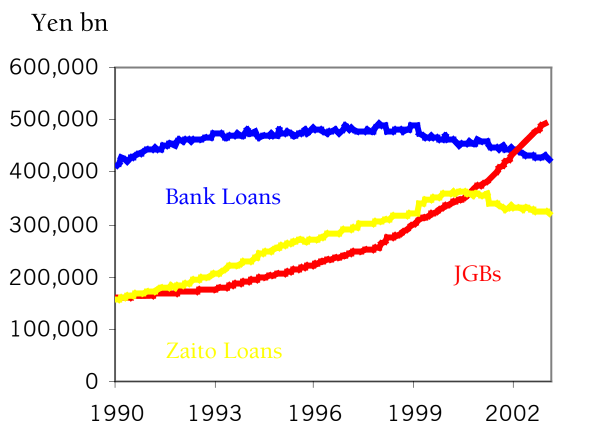
Looking at the Japanese banks it is hard to see them as being able to operate effectively outside the realities of the above described situation. It is true that they have been making progress in writing off bad loans with operating earnings and appear at least on paper much closer to being appropriately capitalised. However when the government is forced to start addressing the size of its debt, it is hard to see how the banks avoid being hurt. If the government chooses to cut spending, the resulting debt deflation scenario will see further bad debts surface and delay recapitalisation. On the other hand a sharp inflation caused by printing of money would also destroy their trading profits (inverted yield curve) and create losses in the large government bond holdings they have amassed in recent years.

JAPANESE DEBT TO GDP



Source: MOF, BOJ

JAPANESE DEBT BREAKDOWN



Source: MOF, BOJ

Outlook

We continue to see good profit results from most of our Japanese holdings, which in the current difficult demand environment is mostly attributable to large cost reductions. However this profit growth is unlikely to continue unless the global economy can provide some decent demand growth and this seems problematic because of the lack of leadership being shown by the US economy. Korea remains uninteresting at this stage until the domestic scene settles down although the market is quite volatile and events in the North could change quite rapidly which would require a quick adjustment. Both markets essentially remain very cheap but lack the catalyst of global growth.

Jim Simpson
Portfolio Manager

A trip to North Korea – February 2003

Nick Harbinson is the Managing Director of Merrill Lynch's Asia's desk. Nick has been living and working in Asia for over 20 years now and this article reflects his personal views and observations.

20km north of the factories where You Eal turns out seventh generation keypads for the global cellular market, the peasants in the fields around Kaesong lack running water, heat and fuel. It is -12C, and under a dusting of snow the ground is solid. Apart from some sickles, hoes and the odd bullock cart, there is no agricultural machinery. On the trip south from Pyongyang, 160km away, the only animals to be seen are a few goats and hens. The contrast in the countryside either side of the 38th parallel is striking. The north is treeless, arid and devoid of vegetation, anything larger than a shrub being gleaned as fuel by the peasants who roam the hillsides tearing off anything they can find and transporting it on rudimentary cradles to their huts. Trench systems are a consistent feature on barren hillsides, and the return journey up the deserted 4-lane Reunification Highway (completed in 1989) provides a clearer view of rows of gun emplacements and pillboxes facing south. The military presence is omniscient.

In the countryside a few miles east of Kaesong we stopped to view the only original surviving burial mounds of one of the Korean dynasties. I opted to walk a portion of the way. Passed by stooped old women carrying bundles of twigs and leaves 10 feet tall on their backs, I avoided a pile of human excrement. It was largely composed of what appeared to be straw.

In the Yangkakdo Hotel, the assortment of international guests (mainly east German steam engine fans) left the breakfast and dinner buffets embarrassingly untouched, and jostled each other at the fried egg stand. There is no milk, and bread made an appearance twice in five days. Hot water was supplied 4 hours daily, although we had heat, and some light. Our Korean minders, in another wing, had neither. In the basement Stanley Ho runs Casino Pyongyang, which sports a massage parlour and karaoke lounge, staffed by Chinese and off limits to the Koreans. Unfortunately, similarities with Macau were few, but here I could defrost my feet and eat immoderately expensive fried rice, priced in euros. In the city itself, crumbling concrete tenements with broken glass and plastic sheeting showed minimal light, and the chimney stacks were lifeless. The shops were predictably bare (no bread, fresh meat or vegetables), with tinned goods and biscuits being the staple items. They were again unheated and poorly lit. In the many cavernous public buildings, we filed past huge murals of the Great Leader, hosted by whey-faced women in overcoats and gloves, and froze politely as we listened to the latest tale of American perfidy or of extraordinary sacrifice in the building of the nation.

The city itself is attractive, with wide, tree-lined boulevards, riverside walks and parks, leading inexorably to yet another war memorial or outsize statue of the Generalissimo. The main public buildings are imposing, more so than those in the southern capital. There is no traffic other than trams and buses, and the occasional bicycle. Most walk. Attractive young women in sky-blue uniforms and jackboots, perform pirouettes as human traffic lights for the intermittent motorist. I wonder what they wear in summer. On the morning of my final day, sirens sounded at 10am and within minutes buses stopped, streets and houses emptied, and the entire population disappeared into subway tunnels and bunkers to freeze for an hour in an air-raid drill. Driving through an abandoned city, attracting the hostile scowls of the few police and soldiers enforcing the curfew, was a surreal experience. One group stopped us and informed me through my translator that, as bombs didn't distinguish between foreigners and Koreans, I should be in a basement too.

Conditions are as bad, or worse, as anything I recall seeing in Eastern Europe, Russia or Albania. But what I found significant was the stoical, almost jovial acceptance of this lifestyle. In contrast to the apathy and cynicism of the eastern bloc, the DPRK gives an impression of bustle, purpose and self-belief that is very striking. I was particularly impressed with the absence of any form of public drunkeness.

This was not an encouraging trip. I came away with the strong conviction that if the most of the Korean bulls (amongst whom I count myself) had any idea of what the world looks like the other side of the DMZ they would be noticeably more cautious in their asset allocation. Granted: the bellicosity of the DPRK regime is long-standing, and the likelihood is that a visitor to this place would have come away dismayed by any visit in the last 20 years. What differs this time is the level of the stakes, the virulence of the rhetoric sparked by the "axis of evil" designation and the palpable anger in the streets.

The DPRK's entire mythology is built around its history of defiance, struggle and victory over the imperialist and capitalist powers, Japanese and American. They date a conspiracy to ensure their economic subservience to 1844, and a motion in Congress authorising the opening of trade. The first attempt at commerce was made a few years later in 1866 when the USS Sherman, a Confederate blockade-runner with a cargo of cotton and tin, reached Pyongyang. A decade earlier on a similar mission Perry had met with Japanese hospitality and Pinkerton his Cho-cho san. The Koreans were less receptive. The Sherman was burnt and its crew massacred thus setting a door policy that many Seoul nightclubs continue to this day.

The DPRK see themselves as the heirs to the patriots of 1866, which is as vivid a part of their national consciousness as the Pueblo incident in 1968, or the shooting down of a US helicopter over the DMZ in 1994. The Peublo, bullet and shrapnel holes emphasised in red paint, floats on the Taedong River on the site of the Sherman's destruction, with the Woodward "apology" prominently displayed. School groups are led through this, and museums of the Korean War that emphasise a history of US hostility and atrocities, including germ warfare and the first airborne delivery of napalm. These exhibits are essential props to a regime that defines itself in relation to a long-running aggression from the US and the west. A year ago it looked as if tentative attempts at a market economy were being introduced, but this remains at heart a marxist-leninist state, which rallies back to its roots when threatened.

In an aging Tupolev on the flight out to Shenyang, I brightened when an attractive young hostess engaged me in conversation. When would I be back, and how many of my friends would I bring with me? She was familiar with Moscow, Bangkok, Beijing, and Khabarovsk, but she said, Pyongyang was far nicer. She was determined to work hard for the Fatherland. Did I understand the basis of the "juche" idea? She was eager to enlighten me. I smiled, realising Dostoyevsky would be easier going, and opened my book.

<u>Nick Harbinson</u>

Editor's comment: Doesn't look too promising from the point of view of unification and the likely cost thereof …